

Helping Law Catch Up to Markets: Applying Broker-Dealer Law to Subprime Mortgages

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"By now everyone knows that reckless and even predatory mortgage lending provoked the financial meltdown."

Editorial, The New York Times, October 19, 2008¹

I. INTRODUCTION

In this Article we make two claims. First, we argue that the current subprime mortgage and credit crisis would have been avoided, or at least greatly mitigated, if existing securities laws had been properly applied to subprime mortgage brokers and originators. Second, we argue that under any of what we regard as three reasonable interpretations of the securities laws, many of the problematic mortgage brokers are actually under the SEC's jurisdiction.² This tantalizing possibility does not appear to have occurred to anybody in this crisis, at least to this point.

Kafka would have loved this story: According to our current understanding of U.S. law, there is far better consumer protection for people who play the stock market than for people who are duped into buying a house with an exotically structured subprime mortgage, even when the mortgage instrument is immediately packaged and sold as part of a security.³ We live on a peculiar legal landscape in which homeowners have almost no recourse under consumer protection laws against people who peddled unsuitable mortgages to them, unless the funds generated by the mortgage financing happened to have been used by the homeowner to purchase securities rather than a house.

The bizarre juxtaposition between the plethora of legal rights afforded participants in the securities markets and the dearth of rights afforded participants in the mortgage market became clear in a lawsuit filed by the SEC on September 29, 2008 against a group of securities brokers in southern California.⁴ These broker-dealers persuaded some of their customers to refinance their houses through a related mortgage company and to take the proceeds of the refinancing and use them to buy exotic securities known as variable universal life (VUL) policies,⁵ which consist of a combination of a life insurance policy

1. Editorial, *The Bubble Keeps on Deflating*, N.Y. TIMES, Oct. 19, 2008, at WK11 [hereinafter *Bubble*].

2. We should briefly note that this would not mean that mortgages would have to be registered, as these mortgages could qualify under the private offering exemptions of the securities laws.

3. Engel and McCoy argue that "[i]f the duty of suitability is appropriate for financial instruments that have been the traditional province of the affluent, certainly it is appropriate for financial instruments that are peddled to the poorest rung of society." Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1319 (2002).

4. Complaint, SEC v. Ainsworth, No. EDCV 08-1350 (C.D. Cal. Sept. 29, 2008), available at <http://www.sec.gov/litigation/complaints/2008/comp20768.pdf>.

5. As the complaint in SEC v. Ainsworth explained:

VUL policies are hybrid investments containing both securities and insurance features. VUL policies are life insurance policies that offer a death benefit to a designated beneficiary combined with an investment in the securities markets. Amounts paid into the VUL beyond the cost of insurance and fees are placed into sub-accounts that are invested into a range of securities funds.

and an investment in equities.

Consider one of the SEC's allegations in their Complaint. The SEC alleged that Gabriel Paredes, the marketing director of World Group Financial and a branch manager at Ainsworth Mortgage, recommended to Lorenzo Pelayo that Pelayo refinance his home with a negative amortization loan and use the proceeds to buy VUL securities.⁶ Pelayo is a 41-year-old truck driver with a weak command of English, four children (ages four, five, seven, and nine), and a combined family income of \$15,000.⁷ Mr. Pelayo made an upfront payment for the VUL securities of \$9000, all of which came from the proceeds of the refinancing. The VUL required monthly premiums in 2006 of \$500, which over the course of the year equated to 40% of the Pelayo family's entire yearly household income. Pelayo's subprime mortgage contained a substantial prepayment penalty and the interest payments were variable rather than fixed, two facts that the SEC alleges were not properly disclosed.⁸ The SEC alleged that the subprime mortgage was an unsuitable way for Pelayo to purchase securities that themselves were unsuitable for him.⁹

The SEC's lawsuit is based on the assumption that the securities laws do not apply to these (or any other) mortgages. While mortgages are financial instruments for which the SEC does not claim jurisdiction, the SEC is taking the position that because the proceeds of the negative amortization mortgages were used to finance purchases of other financial instruments over which the SEC does have jurisdiction—the VUL securities—the entire transaction is covered by the securities laws, which ban fraudulent or misleading practices “in connection with” the purchase or sale of securities.¹⁰ If Mr. Pelayo had used the proceeds of his refinancing to buy food or other necessities, the SEC would never have become involved in the case. It was an anomaly—the fact that that the proceeds of the subprime mortgage financing were used to buy securities rather than food, clothing, or shelter—that made the case of interest to the SEC.

The point of this Article is to explore the different relationships underlying the governance of securities markets and mortgage transactions. We begin with the observation that there is a fiduciary relationship between customers and their brokers underlying securities transactions while caveat emptor governs the mortgage relationship. Legally, the dichotomy in the legal treatment of people who engage in mortgage financing and people who engage in securities transactions is based on two unexamined assumptions. The primary assumption is that mortgages are not securities, and the brokers who sell them are not securities broker-dealers, and therefore customers who deal in

The sub-accounts are subject to market risk and build value based upon the performance of the customers' investment choices.

Id. at 8.

6. *Id.* at 36–38.

7. The Pelayos' combined family income was \$35,000 in 2007, but since the financing transaction occurred in 2006, that year's income of \$15,000 is more relevant. *See id.* at 37 (“For the year ending 2006 the Pelayo family earned a combined income of \$15,000, and roughly \$35,000 in 2007.”).

8. “Parades [sic] did not disclose to Pelayo that his new mortgage was a negative amortization adjustable rate loan, and therefore, despite making monthly payments, the principal balance would continue to increase. Pelayo was not told that his mortgage interest rate could increase. Paredes did not disclose that Pelayo's mortgage loan had a prepayment penalty.” *Id.* at 37–38.

9. Complaint, *supra* note 4, at 38.

10. “Defendants fraudulently sold unsuitable securities to their customers financed by sub-prime mortgage refinancing.” *Id.* at 7.

mortgages do not qualify for the standard consumer protection scheme available to people who deal in securities. The second assumption is that even where the issuance of a mortgage is part of a securitization process in which the mortgage payments will be bundled together with other mortgage payments and sold as securities the protections of the SEC's catch-all antifraud provision, Rule 10b-5, do not apply. For Rule 10b-5 to apply to a transaction, all that is required is that there be a misrepresentation or omission of a material fact "in connection with the purchase or sale of any security."¹¹ It seems clear, at least to us, that the issuance of a mortgage as an integral part of a securitization is a transaction "in connection with the purchase or sale of any security."¹²

We take the view that this distinction, however valid it may have been in the past with respect to mortgage financings, no longer makes sense. Fundamental changes in the mortgage market and in the characteristics of mortgages themselves have transformed mortgage brokers into peddlers of financial instruments that share more than enough characteristics with the financial instruments that we call "securities" to permit people who obtain mortgages to qualify for certain legal protections that are routinely afforded those who transact in securities.

Part II of this Article describes how the evolution of the mortgage industry has dramatically changed the economic properties of the financial products known as mortgages. We describe the growth of the subprime mortgage industry and the peculiar aspects of these transactions that make them entirely different from standard 30-year prime mortgages. We also briefly discuss the current (inadequate) protections for subprime borrowers. In Part III we give two independent arguments why the legal protections that apply to securities should also apply to protect purchasers of certain mortgage instruments, particularly so-called subprime mortgages. First we explore reasons for treatment of the subprime mortgage instruments as securities. We then make an innovative argument about how securitization has turned mortgages into products created "in connection with the purchase or sale of a security."¹³ Under this line of argument the mortgage itself is not a security, but those brokering mortgage deals are

11. Rule 10b-5 states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (2008).

12. We are investigating the relationship between subprime mortgage treatment and the treatment of "swap transactions" under the securities laws. Swap transactions are not securities and are not regulated as such, but those engaging in transactions are liable under the antifraud rules of the securities acts. See Robert F. Schwartz, *Risk Distribution in the Capital Markets: Credit Default Swap, Insurance, and a Theory of Demarcation*, 12 FORDHAM J. CORP. & FIN. L. 167, 172 & n.17. Since this is what we are trying to achieve to get suitability, it may be that this "intermediate scrutiny" is sufficient for our purposes.

13. See Rule 10b-5, 17 C.F.R. § 240.10b-5 (2008).

responsible for violations of Rule 10b-5. In Part IV we explore why we might want such oversight for subprime mortgage brokers. We introduce one of the basic protections that exist for retail customers who purchase or sell securities, known as suitability. We then discuss previous attempts to introduce suitability into the mortgage industry and distinguish them from our proposal. In Part V we argue that if our approach would have been followed, much of the current economic misery confronting markets worldwide would have been avoided. Finally, in Part VI we speculate about why our suggested approach has not been previously considered, and address the likely fate of legal challenges to an SEC rule adopting our proposal.

II. FROM CONSUMPTION TO INVESTMENT: THE TRANSFORMATION OF THE MORTGAGE INDUSTRY

In a mortgage loan,¹⁴ as in most loans, a lender (mortgagee) provides capital to a borrower (mortgagor) in return for the borrower's agreement to provide the lender a stream of payments in the future that pay back the principal amount of the loan plus interest. Because of the long stream of payments involved, a mortgage can be viewed as a type of annuity. The lender receives the payments and has a "long" position in the annuity; the borrower makes the payments and has a "short" position in the annuity. The distinguishing feature of a mortgage is that it involves the pledge of property as security for the mortgage loan.¹⁵

A. The Evolution of Mortgages

Historically, mortgage loans have had 30-year maturities.¹⁶ This long time horizon allows home purchasers to spread the cost out over a large percentage of a working career and avoid the need to have all the money upfront at the time of purchase. In the past, a vast majority of the loans originated were fixed-rate loans on which the charged interest rate remained constant over time. Because market interest rates vary over time, such a loan structure subjects both the lender and the borrower to interest rate risk, though the borrower can mitigate the risk through prepayment.¹⁷

An alternative framework in the form of the floating-rate loan emerged. With a floating-rate loan, the interest payment is tied to a variable interest rate such as the London Interbank Offering Rate (LIBOR). The most common arrangement is the 2/28 adjustable rate mortgage (ARM), a form of mortgage that has a fixed rate for the first two years of the mortgage but a floating rate for the 28 years thereafter. Because floating rates

14. The "mortgage" itself is simply the legal agreement under which the property is pledged as collateral, though the term is often used to connote the entire loan transaction. See DAVID S. HILL & CAROL NECOLE BROWN, *BASIC MORTGAGE LAW* 19–20 (2d ed. 2007) (defining and describing the concept of a mortgage).

15. The mortgage itself is a transfer of an interest in land from the owner of the land to the person loaning money and taking the mortgage as security for the loan. *Id.*

16. For a thorough background of the growth of the mortgage industry, see EDWARD M. GRAMLICH, *SUBPRIME MORTGAGES: AMERICA'S LATEST BOOM AND BUST* (2006).

17. Lenders were subject to more risk than borrowers because, if interest rates declined, borrowers would repay their mortgages early (known as prepayment) by refinancing their homes at the new, lower rates. On the other hand, if interest rates increased, borrowers would simply decline to prepay, thereby creating an opportunity cost for the lender who would like to have the principal back to loan out at the new, higher rate of interest.

can, and will, vary over the life of the mortgage, an ARM is generally riskier for the borrower. This risk is compounded if, as is often the case, the fixed-rate part of the contract was set to a low “teaser rate,” almost guaranteeing that the subsequent variable rate would be substantially higher.¹⁸ The “payment shock” that has accompanied the switch from low fixed to high floating rates has been a major contributor to the subprime crisis.¹⁹

Another innovation in the mortgage industry was the changes in the amount of principal required to be paid along with each interest payment, referred to as amortization. The standard mortgage loan is self-amortizing, meaning that the entire principal of the loan is paid off gradually by the time the loan matures. More recent lending has seen the rise of mortgage loans that do not self-amortize; for example, “interest-only loans” require only the interest to be paid, leaving the principal constant. Such nonamortizing loans are riskier for the borrower because when the principal becomes due at the end of the mortgage term, the borrower may not have put aside enough in savings to pay the outstanding balance (and may not be able to obtain a refinancing of the mortgage at an affordable rate). Thus, “interest-only loans” also contribute to a greater probability of default. Similarly, “option ARMs” are mortgage loans in which the monthly interest payments made by the borrower are *less* than the monthly interest that actually accrues on the loan.²⁰ These loans result in negative amortization loans because the unpaid interest is added to the principal and, thus, the repayment schedule causes the principal value of the loans to increase over time. Such loans, popularly known as “pick-a-pay” mortgages, appeal to consumers, and feature a low minimum payment—usually one percent, at least for a while.²¹ Borrowers with such loans usually make only the trivial minimum payment due each month rather than the actual interest rate. This serves only to delay the time when the borrower must pay the actual interest owed. “Pick-a-pay” mortgages were wildly popular for a time, and were even featured on the covers of popular magazines and newspapers.

Another big change in the mortgage industry was the transition from an industry in which the people offering mortgages worked on a salary basis (for firms that planned to keep the mortgages as assets on their portfolios for decades in the future) into an industry in which mortgage brokers working on commissions knew that the mortgages being issued would immediately be sliced and diced and repackaged into securities. Individual mortgage brokers were indifferent to future defaults in the mortgages that they issued, in

18. Kenneth R. Harney, *Guidelines to Close Some Doors to Subprime Loans*, CHI. TRIB., July 8, 2007, at 2; Press Release, Senator Sherrod Brown, Senate Comm. on Banking, Hous., & Urban Affairs, Second Annual Monetary Policy Report to the Congress (July 19, 2007) [hereinafter Brown Press Release], available at http://brown.senate.gov/newsroom/press_releases/release/?id=f891f77b-7f90-47d7-91ae-90863bf24aad.

19. Senator Sherrod Brown noted:

[T]he loans in the subprime sector, like the 2/28s, seemed almost designed to deceive. They are sold to borrowers at teaser rates, with dangerous features, and with the smooth pitch that there is no need to worry about the reset because good things might happen—a better job, a better loan, winning the lottery. But banking on the outcome is not a sound banking practice.

Brown Press Release, *supra* note 18.

20. See Michael Moss & Geraldine Fabrikant, *Once Trusted Mortgage Pioneers, Now Pariahs*, N.Y. TIMES, Dec. 25, 2008, at A1.

21. *Id.*

large part because such defaults in no way affected their compensation or reputation.

One example of the evolution in the structure of the industry is the emergence of the yield spread premium (YSP), a device developed to provide incentives for mortgage brokers to loan to poor people. A YSP is paid from an originator to a mortgage broker, often when a borrower takes a mortgage with an interest rate that is higher than the interest rate on an ordinary, garden-variety mortgage.²² In this sense, it is a kickback. Suppose, for example, that a particular lender is offering basic mortgages at an interest rate of six percent. Usually, lenders will also provide mortgage brokers with other higher interest alternatives—often, but not always—in return for lower closing costs or other concessions on the part of the lender. Whenever a broker is able to convince a borrower to accept a mortgage with a rate higher than the base rate of six percent, that broker is paid a fee (the YSP) equal to some percentage of the increased spread being paid by the borrower. This of course inevitably has led to situations in which “mortgage brokers steer borrowers to the lender that pays the highest fees to the broker.”²³

Mortgage loans once were made by banks that originated, funded, and serviced the loans. Today—or at least until the mortgage crisis hit in full force in 2008—mortgage loans are originated by entities that rarely retain the loan longer than it takes to deliver the mortgage to the next entity in the mortgage food chain. Rather than shop between banks, an individual seeking a mortgage loan often will employ the services of a mortgage broker, who acts as an intermediary between the borrower and the lender. Mortgage brokers receive a commission for their work that may depend on the loan’s interest rate and other terms. The common use of the term “broker” in the nomenclature used for intermediaries in the mortgage and securities industry is not a coincidence; the roles of mortgage broker and securities broker are functionally equivalent.

Mortgage loans are actually a form of derivative security because they contain imbedded options.²⁴ Understanding these options is crucial to understanding how mortgages should be valued, why a secondary market in which mortgages are pooled developed, and, most importantly for the purposes of this Article, why mortgages can be viewed as a transactional form for the purchase of such options rather than simply as a financial instrument in itself.²⁵

Financial options are of two general types: puts and calls. In a call option the holder (buyer) of the option has the right, but not the obligation, to purchase a security from the writer (or seller) for a predetermined price.²⁶ The agreed-upon date is known as the “exercise date” and the predetermined price is known as the “strike price.” A rational

22. Lloyd T. Wilson, Jr., *Effecting Responsibility in the Mortgage Broker-Borrower Relationship: A Role for Agency Principles in Predatory Lending Regulation*, 73 U. CIN. L. REV. 1471, 1514–15 (2005).

23. Alistair Barr, *Subprime Crisis Shines Light on Mortgage Brokers*, MARKET WATCH, Apr. 10, 2007, <http://www.marketwatch.com/news/story/subprime-crisis-shines-spotlight-mortgage/story.aspx?guid=%7B5343C57B-AB5B-4D90-A9D4-AF9A76F7D9B3%7D>.

24. See, e.g., Roberto G. Quercia & Michael A. Stegman, *Residential Mortgage Default, A Review of the Literature*, 3 J. HOUSING RES. 341, 357–59 (1992) (providing a history of financial conceptualizations of mortgage loans).

25. The legal academy has come to appreciate the importance of options and option theory, both financial and real, as a way of understanding legal constructs and bundles of rights. See generally IAN AYRES, *OPTIONAL LAW: THE STRUCTURE OF LEGAL ENTITLEMENTS* (2005).

26. For more on financial options, see JOHN C. HULL, *OPTIONS, FUTURES, AND OTHER DERIVATIVES* (6th ed. 2005).

option holder will only choose to purchase the security (known as “exercising the option”) if the strike price on the exercise date is less than the current price of the security. Otherwise, the holder will choose to let the option expire, unexercised. A put option is the inverse of the call option; it is the right, but not the obligation, to sell a security to the writer on the exercise date for the strike price.

A mortgage borrower holds, or in finance parlance is “long,” two different options, each written by the mortgage lender implicitly through the mortgage loan contract. The first of these options is the right to prepay the loan before its²⁷ maturity.²⁸ Recalling our earlier depiction of a mortgage as an annuity (or stream of payments), the borrower has the right to buy back his obligation to make that stream of payments by giving the mortgage lender the outstanding balance on the loan. Thus, the borrower has a call option (the right to buy) with an exercise price set to the outstanding balance amount at any point over the life of the mortgage. The lender has written this call option.

A borrower may prepay for a variety of reasons. Some borrowers wish to eliminate their mortgages: they may sell their house or come into money and wish to reduce their indebtedness, for example. Prepayments also occur as an incident to refinancing. Borrowers may refinance because they wish to borrow more money in order to meet liquidity needs—to obtain money for home improvements or education expenses, for example. Additional borrowing is possible if: the original loan was small relative to the house’s value, the home has appreciated in value over the time the loan has been outstanding,²⁹ the borrower has paid down much of the principal of the loan, or the borrower’s creditworthiness has increased.³⁰ Borrowers may also refinance if mortgage interest rates decline,³¹ either because of changes in market rates or because the borrower’s creditworthiness has improved.³² A rational borrower will refinance when the

27. Zywicki and Adamson also discuss financial options, including prepayment and foreclosure, in the context of subprime mortgages. Todd J. Zywicki & Joseph D. Adamson, *The Law & Economics of Subprime Lending*, 80 U. COLO. L. REV. (forthcoming 2009) (manuscript at 24–35), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1106907.

28. Bruce S. Darringer, *Swaps, Banks, and Capital: An Analysis of Swap Risks and a Critical Assessment of the Basle Accord’s Treatment of Swaps*, 16 U. PA. J. INT’L BUS. L. 259, 329 (1995); Gerson S. Goldberg & John P. Harding, *Investment Characteristics of Low- and Moderate-Income Mortgage Loans*, 12 J. HOUSING ECON. 151, 153 (2003); Peter H. Huang, *A New Options Theory for Risk Multipliers of Attorney’s Fees in Federal Civil Rights Litigation*, 73 N.Y.U. L. REV. 1943, 1946 n.12 (1998); Peter H. Huang, *A Normative Analysis of New Financially Engineered Derivatives*, 73 S. CAL. L. REV. 471, 483–84 (2000); Melissa S. Jacoby, *Home Ownership Risk Beyond a Subprime Crisis: The Role of Delinquency Management*, 76 FORDHAM L. REV. 2261, 2267 (2008).

29. See Akash Deep & Dietrich Domanski, *Housing Markets and Economic Growth: Lessons from the US Refinancing Boom*, BIS Q. REV., Sept. 2002, at 37–38 (discussing the various reasons for the increased numbers of mortgage refinancing in 2001).

30. Of course, this is a simplification. Unemployment generally decreases when the economy is doing well and, as such, this reason is also tied into macroeconomic trends. Yet there is something different about this reason that is much more individualized and less cyclical than the others, since prevailing interest rates (and, to a lesser extent, housing prices) change for all in the economy simultaneously while individual job changes and other credit-enhancing events do not.

31. See Edward L. Pittman, *Economic and Regulatory Developments Affecting Mortgage Related Securities*, 64 NOTRE DAME L. REV. 497, 504 n.29 (1989) (stating that “if interest rates fall, mortgagors are likely to refinance”).

32. In many ways, this is similar to arguments made regarding the individualized and noncyclical nature of reasons for mortgage defaults, put forward by the Mortgage Bankers’ Association in arguing against a

difference between the current mortgage loan and the potential new loan is greater than the transaction costs incurred in refinancing.

A second option implicit in the mortgage is a default option. The borrower can, at any time,³³ stop paying interest and principal payments and surrender the property used as collateral for the mortgage. Borrowers will choose to exercise this option to sell, or “put,” the collateral back to the lender if and only if the value of the house securing the mortgage loan is less than the present value of the amount left to be repaid on the loan.³⁴ Exercising the put option requires defaulting on the loan, which means the borrower will lose the house; as a result it is only prudent to do so if the value gained by not having to pay the remaining balance on the mortgage loan outweighs the amount lost by giving up the house. Of course, the borrower may also face additional costs in terms of future credit scores and the like in exercising this default option. In some states, in addition, the holder of the mortgage can, in theory, proceed against the personal assets of the borrower.³⁵ As a practical matter, however, and especially in the case of subprime mortgages, this is not a viable option. Some states require mortgage loans to be “nonrecourse,” meaning that the holder of the mortgage has no right to seek repayment except from the collateral.³⁶ Even in states that permit recourse loans, the fact that the defaulting borrower could not pay mortgage payments means that the borrower is unlikely to have assets of sufficient size to make such litigation a feasible alternative.

From the point of view of the lender, however, having written (or taken the short position in) the prepayment and default options means that the lender will receive back either the outstanding mortgage funds, or the property itself, at the most inopportune moments. In particular, significantly declining interest rates lead to a rash of refinancing.³⁷ In such an environment, lenders will lose an asset paying them high interest rates (the mortgage), and will only be able to replace it with lower interest rate securities they can purchase in the open market. However, rising interest rates do not produce a mirror-image phenomenon; borrowers faced with rising interest rates will continue paying off mortgage loans at the lower originated rate, leaving lenders with an asset paying less than the prevailing market rate. To protect lenders against this so-called “interest rate risk,” many subprime mortgage loans include a prepayment penalty—an additional charge the borrower must pay when paying the loan balance back before the

suitability standard. See MORTGAGE BANKERS ASS'N, POLICY PAPER 2007-1, SUITABILITY—DON'T TURN BACK THE CLOCK ON FAIR LENDING AND HOMEOWNERSHIP GAINS (2007), available at http://www.mbaa.org/files/News/InternalResource/48134_Suitability-DontTurnBackTheClockonFairLendingandHomeownershipGains.pdf.

33. Technically, this is an American option, which can be exercised at any time up to the exercise date, as opposed to a European option, which can only be exercised on the exercise date itself. This changes the valuation and optimal exercise strategy, but the theoretical construct laid out here remains the same.

34. See, e.g., Brent W. Ambrose, Charles A. Capone, Jr. & Yongheng Deng, *Optimal Put Exercise: An Empirical Examination of Conditions for Mortgage Foreclosure*, 23 J. REAL ESTATE FIN. 213 (2001); Goldberg & Harding, *supra* note 28, at 153; Jacoby, *supra* note 28, at 2267; Quercia & Stegman, *supra* note 24 at 357–59.

35. See Jane Birnbaum, *A Break for Freddie and Fannie*, N.Y. TIMES, Mar. 20, 2008, at C1.

36. For a list of nonrecourse mortgage states, see HELOC Basics, List of Non-Recourse Mortgage States and Anti-Deficiency Statutes, <http://www.helocbasics.com/list-of-non-recourse-mortgage-states-and-anti-deficiency-statutes> (last visited Mar. 26, 2009).

37. See Pittman, *supra* note 31, at 504 n.29 (“If interest rates fall, mortgagors are likely to refinance . . .”).

due date.³⁸ Prepayment penalties do not make refinancing impossible, but they raise the transaction cost associated with switching from one mortgage loan to another and hence can be viewed as increasing the strike price of the refinancing option.

Refinancing also tends to occur when home prices appreciate.³⁹ Such appreciation means that the collateral a borrower is willing to pledge is worth more to potential lenders. As a result, a borrower can refinance into a larger loan or, perhaps, into a loan of the same size with a better interest rate. A third cause of refinancing is an individual's increase in creditworthiness, which is specific to individual borrowers and is not closely tied to macroeconomic trends.⁴⁰ The mortgage rate an individual can obtain depends in part on the lender's perception of that person's ability to repay the mortgage loan without delinquency. A lifestyle change such as obtaining a new high-paying job or marrying a rich spouse may increase the actuarial probability of repayment and, as a result, decrease the amount of interest a lender charges for an otherwise identical loan.⁴¹ Faced with such a credit-enhancing lifestyle change, an individual will choose to refinance if the loan price difference is greater than transaction costs. While prepayment penalty clauses do not distinguish between reasons for refinancing, it is worth noting that lenders receive the prepayment amount in this situation regardless of whether interest rates are increasing, decreasing, or remaining steady, as prepayment penalties are usually independent of this fact.

Combining the default and prepayment options with the stream of payments normally required of the mortgage lender means that the mortgage loan can be conceived as a financial instrument consisting of an annuity held by the lender and two different options written by the lender and held by the borrower.⁴² As a result, it is natural to think of a mortgage loan as a security particularly because the term "security" has been defined very broadly to encompass not only such things as stocks, bonds, and mutual fund shares, but also notes, evidences of indebtedness, certificates of participation in any profit-sharing venture, certificates of deposit, and, most puts, calls, straddles, and options on any security or group or index of securities.

B. Subprime Mortgages

Subprime lending is the making of loans to people with less than perfect creditworthiness. It is a category contrasted with prime lending, loans made to people with perfect (or near perfect) credit scores. The subprime mortgage market has increased drastically in size over the past 15 years,⁴³ for reasons that will be discussed more fully

38. On prepayment penalties, see generally Engel & McCoy, *supra* note 3.

39. See Deep & Domanski, *supra* note 29, at 37-38 (discussing the various reasons for the increased numbers of mortgage refinancing in 2001).

40. See *supra* note 30.

41. In many ways, this is similar to arguments made regarding the individualized and noncyclical nature of reasons for mortgage defaults put forward by the Mortgage Bankers' Association in arguing against a suitability standard. See MORTGAGE BANKERS ASS'N, *supra* note 32, at 24 (explaining that delinquencies result from a variety of factors, including family and economic difficulties).

42. "[T]he mortgage value is equal to the value of a noncallable, nondefaultable, bond less the market value of the two imbedded options." Goldberg & Harding, *supra* note 28, at 153.

43. Faten Sabry & Thomas Schopflocher, *The Subprime Meltdown: A Primer*, in THE SUBPRIME MORTGAGE MELTDOWN: WHO, WHAT, WHERE AND WHY . . . INVESTIGATIONS & LITIGATION 89, 91 (PLI Corp.

below. While “subprime” is nomenclature rather than an official designation, various rules of thumb for what constitutes a subprime borrower have started to emerge. The first is that a subprime borrower is one with a FICO score of less than 620 on the standard 300 to 850 creditworthiness scale developed by the Fair Isaac Company.⁴⁴ Alternatively, a more functional definition considers a subprime mortgage to be any mortgage that is nonconforming (i.e., not purchasable by the Government Sponsored Entities (GSEs)) because of its level of riskiness.⁴⁵ Regardless of the rubric used, the key point is that subprime loans are those to borrowers whose risk profile makes default a more realistic possibility than for those made to prime borrowers.

Traditionally, most American mortgage lending was done to individuals with perfect or near-perfect credit (prime borrowers) by banks or thrifts that held on to the loans and provided all the necessary servicing and documentation.⁴⁶ These loans were fixed rate and required a host of additional costs such as closing fees, private mortgage insurance, and the like.⁴⁷ These terms and the credit requirements meant that only middle- and upper-class Americans were able to obtain mortgages, making it hard for large segments of the population to own homes.⁴⁸ Racial discrimination made homeownership even harder for minorities.⁴⁹

Borrower delinquency during the Great Depression forced the federal government to act. Among other measures, the government created a secondary market for mortgage loans through its creation of Fannie Mae, later joined by Ginnie Mae in 1968 and Freddie

Law & Practice, Course Handbook Series No. 15,783, 2007) (citing Sandra F. Braunstein, Dir., Div. of Consumer & Cmty. Affairs, Fed. Reserve Bd., Testimony on Subprime Mortgages Before the Subcommittee On Financial Instruments and Consumer Credit, House Committee on Financial Services (Mar. 27, 2007)).

44. On FICO scores generally, see Toddi Gutner, *Anatomy of a Credit Score*, BUS. WK., Nov. 28, 2005, at 116, available at http://www.businessweek.com/magazine/content/05_48/b3961124.htm. For the 620 threshold definition of subprime borrowers, see Travis P. Nelson, *The Current Subprime Mortgage Environment: Trends and Implications*, BANKING L. COMMITTEE J. (Am. Bar Assoc., Chi., Ill.), July 2007, at 1, available at <http://www.abanet.org/buslaw/committees/CL130000pub/newsletter/200708/nelson.pdf>, and Sabry & Schopflocher, *supra* note 43, at 92 (noting that “[i]t is generally accepted that a FICO score less than 620 is considered subprime”).

45. See Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2214 (2007) (noting that subprime mortgages are usually made to borrowers who have “problematic credit histories”).

46. See Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2049 (2007) (explaining that, in the past, the lender held on to loans and therefore carried the risk of default, a risk that discouraged lenders from making risky loan); David Reiss, *Subprime Standardization: How Rating Agencies Allow Predatory Lending to Flourish in the Secondary Mortgage Market*, 33 FLA. ST. U. L. REV. 985, 992–93 (2006). For great descriptions of the growth of the subprime mortgage industry, on which this short summary is based, see GRAMLICH, *supra* note 16, at 1–12 (providing an overview of home lending changes since World War II), Peterson, *supra* note 45, at 2191–94 (providing a brief history of the origins of home mortgage lending), and *Subprime Mortgage Market Turmoil: Examining the Role of Securitization: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs, Subcomm. on Security, Insurance, and Investment*, 110th Cong. 1–2 (2007) (testimony of Christopher L. Peterson, Assoc. Professor of Law, Univ. of Fla.) [hereinafter Peterson Testimony], available at http://banking.senate.gov/_files/ACFE4F.pdf.

47. GRAMLICH, *supra* note 16, at 1–6.

48. *Id.*

49. See Celeste M. Hammond, *Predatory Lending—A Legal Definition and Update*, 34 REAL EST. L.J. 176, 182–85 (2005) (citing cases, beginning in the 1970s, where courts found builders charged unreasonably high prices for homes sold to minorities and lenders charged unreasonably high interest rates to minority home buyers); Peterson, *supra* note 45, at 2192.

Mac in 1970.⁵⁰ These GSEs bought loans from banks and thrifts, giving these lenders more funds with which to make loans.⁵¹ As a result, lenders could loosen underwriting standards and provide more loans with more favorable terms.⁵² In the 1970s, as financial understanding of mortgage lending increased, the GSEs began to pool these mortgages and issue securities based on them—so-called “mortgage-backed securities.”⁵³ This further provided funding to the mortgage industry and increased lending. However, the GSEs’ impact has historically been limited because of their ability to only buy “conforming loans” from banks and thrifts, which limits loans to below a certain principal amount and does not include most subprime loans.⁵⁴

As time went on, private banks began to buy and securitize more risky loans, including subprime loans.⁵⁵ The securitization of these loans, at a high level of generality, involved purchasing a pool of loans, selling them to a special-purpose vehicle (SPV) created for the purpose, and having the SPV issue notes backed by the loans.⁵⁶ These notes, generally referred to as collateralized debt obligations (CDOs) or collateralized mortgage obligations (CMOs) divide the income stream from the loans into several levels, or tranches, that have a seniority structure. Income from the loans goes to the most senior tranches first. The tranching structure, in addition to the fact that the notes are often over-collateralized and may have credit support, allows the most senior tranches to receive AAA ratings, making them appropriate for investment by mutual funds and pension plans even though the underlying asset is risky debt.⁵⁷ As a result of this innovation, a large amount of capital flowed into the subprime mortgage industry, making credit available on cheaper terms to borrowers with varying levels of credit.

The influx of money into the subprime mortgage lending industry resulting from collateralization and securitization of loans had a number of effects beyond an increase in the number of American homeowners. First, property prices began to rise on account of increased demand from successful borrowers,⁵⁸ which, according to the theory above,⁵⁹

50. Peterson, *supra* note 45, at 2196–99; Peterson Testimony, *supra* note 46, at 2.

51. See Dale Ledbetter, *Understanding the Sub-Prime Debacle*, in THE SUBPRIME MORTGAGE MELTDOWN, *supra* note 43, at 39 (explaining that GSEs brought “liquidity to the conforming mortgage markets”).

52. Peterson, *supra* note 45, at 2196; Reiss, *supra* note 46, at 1005–06.

53. See Reiss, *supra* note 46, at 1007 (listing the creation of residential mortgage-backed securities in the 1970s as the first stage of securitization); Sabry & Schopflocher, *supra* note 43, at 94–95 (defining securitization).

54. See Reiss, *supra* note 46, at 1010–11.

55. See Peterson, *supra* note 45, at 2198–2200 (explaining how Ginnie Mae and Freddie Mac began issuing mortgage-backed securities and how private institutions quickly followed suit). For some legal changes that also helped in the development of subprime mortgages, see Zywicki & Adamson, *supra* note 27, at 5–6.

56. This is, of course, an oversimplification of the process. For a detailed look at securitization, see Peterson Testimony, *supra* note 46, at 4–8; Engel & McCoy, *supra* note 3, at 1273–74; Engel & McCoy, *supra* note 46, at 2045–48; Sabry & Schopflocher, *supra* note 43, at 95–98; David J. Weiner, Comment, *Assignee Liability in State Predatory Lending Laws: How Uncapped Punitive Damages Threaten the Secondary Mortgage Market*, 55 EMORY L.J. 535, 549–53 (2006).

57. See Peterson Testimony, *supra* note 46, at 5 (explaining that investors look closely at the credit ratings of tranches); Peterson, *supra* note 45, at 2202–04 (explaining the development, purpose, and structure of tranches); Sabry & Schopflocher, *supra* note 43, at 96–97 (citing tranching as the most common internal credit enhancement mechanism).

58. Ledbetter, *supra* note 51, at 40.

59. This is as we would expect under the option theory of mortgages described above. See *supra* notes 26–

encouraged refinancing of loans and entrance into home equity loans. Second, the terms of mortgages began to change, as detailed thoroughly below. Third, because the originators and brokers did not hold the loans they created, standards and diligence in originating loans were compromised.⁶⁰ This had the positive consequence of more homeownership but the negative consequence of adding complex terms that borrowers may not have wanted or understood and a reduced focus by originators on the borrower's ability to pay.⁶¹ As Federal Reserve Chairman Ben Bernanke noted:

[T]he . . . rapid expansion of the subprime market was clearly accompanied by deterioration in underwriting standards and, in some cases, by abusive lending practices and outright fraud. In addition, some households took on mortgage obligations they could not meet, perhaps in some cases because they did not fully understand the terms.⁶²

In short, the increased prevalence of subprime loans has had a major impact on the way individuals have borrowed to purchase homes and to refinance.

As mentioned above, subprime mortgage lending involves a different set of loan terms than prime mortgage lending. For holding the additional risk correlated with low credit scores, subprime lenders demand additional expected return, primarily in the form of interest rates higher than the rates that are charged for prime mortgages. There are a number of other terms common to subprime loans, present either because of the risk profile of subprime borrowers or the need of lenders to counteract the lower expected repayment rate of this group.

One common term is a prepayment penalty, a charge to the mortgage holder for paying off a mortgage before the payments are due.⁶³ Prepayment penalties are present in roughly 80% of subprime loans but only 2% of prime loans.⁶⁴ As discussed above, a prepayment penalty protects the lender from the situation in which market interest rates decline, making refinancing attractive to the borrower as a way of paying off the higher rate mortgage. Due to the lower interest rates, this essentially swaps a high-rate-paying

32 and accompanying text.

60. See Peterson, *supra* note 45, at 2269–71 (explaining that securitization allows originators to rid themselves of the loans they originate, so that even if a judgment is entered against them, they have no assets to pay the judgment).

61. See Hammond, *supra* note 49, at 179 (listing common predatory lending practices, including having borrowers overstate their income); Keith W. Miller & Matthew R. Paul, *Subprime Mortgage Meltdown: Is Litigation on Its Way?*, in THE SUBPRIME MORTGAGE MELTDOWN, *supra* note 43, at 15, 17; David J. Marx, *How Things Changed*, ORIGINATION NEWS, Jan. 1, 2008, at 4, available at <http://www.originationnews.com/plus/archive/?id=158128>; Peterson Testimony, *supra* note 46, at 13; Sabry & Schopflocher, *supra* note 43, at 99–100 (citing the “relaxation of underwriting standards” as a commonly-cited cause of the subprime mortgage crisis).

62. Ben Bernanke, Chairman, Federal Reserve, Semiannual Monetary Policy Report to the Congress, Testimony Before the Senate Committee on Banking, Housing, and Urban Affairs (July 19, 2007) [hereinafter Bernanke Testimony], available at <http://www.federalreserve.gov/newevents/testimony/bernanke20070718a.htm>.

63. For a judicial description of prepayment penalties, see *Banca Cremi, S.A. v. Alex. Brown & Sons, Inc.*, 132 F.3d 1017, 1022–23 (4th Cir. 1997). For a discussion of prepayment penalties in the subprime mortgage context, see Zywicki & Adamson, *supra* note 27, at 15–19.

64. Weiner, *supra* note 56, at 548 (citing ERIC STEIN, QUANTIFYING THE ECONOMIC COST OF PREDATORY LENDING: A REPORT FROM THE COALITION FOR RESPONSIBLE LENDING 8 (2001), available at <http://www.responsiblelending.org/pdfs/Quant10-01.pdf>).

asset in the hands of the mortgage originator for whatever they can lend at the prevailing lower interest rate.⁶⁵ Prepayment penalties mitigate this risk by providing an incentive for borrowers against prepayment or, if the interest rates decline enough to make prepayment still profitable for the borrower, defraying some of the cost to the lender of the prepayment. As will be discussed later in this Article, some have a more cynical view of prepayment penalties and consider them to be predatory in nature.

Originators of subprime mortgages often require a payment of a certain number of percentage “points” upfront at origination of the mortgage. The extent of such payment depends on the individual loan, but is higher for subprime mortgages than for their prime counterparts. Points are another form of protection against prepayment, but they also serve to protect against potential default by borrowers since a portion of the loan will have been repaid regardless of subsequent credit events.⁶⁶

As one mortgage expert observed in an article on subprime mortgages, the draconian reset features were not a problem initially as long as “house values increased year after year at a higher rate than associated interest rates.”⁶⁷ This is no longer the case. These loans were aggressively marketed; “brokers and loan officers began pushing these loans hard as banks offered rebates of up to 3.5% on the back-end.”⁶⁸ Whether consumers understood these complicated contracts is debatable. For example, with a “pick-a-pay” loan, “[m]ost consumers don’t really know what they’re getting aside from the super low minimum payment option, mainly because brokers and loan officers tend to push that aspect of the loan above all else.”⁶⁹

Subprime loans are used not only to purchase homes, but also to refinance. As described above,⁷⁰ mortgage borrowers hold an option to refinance their mortgage loans. This option may be exercised for a number of reasons, including an improvement in lending rates or an increase in expenses accompanied by home equity.⁷¹ Recall that subprime loans often feature two-year low “teaser” rates before switching to a high floating-interest rate. Subprime borrowers, faced with this structure and increasing home values, began a cycle of refinancing upon the end of the two-year “teaser” period. If housing prices continued to rise, the increasing equity in the mortgaged property would have allowed this to continue indefinitely, shielding borrowers from high floating rates. Indeed, subprime borrowers able to afford the low “teaser” rates but not the high floating rates relied on the ability to engage in exactly this type of refinancing.

The subprime mortgage market began to collapse in 2006. In short, the rising real

65. See Sabry & Schopflocher, *supra* note 43, at 97 (explaining the effect of interest rate changes on homeowners).

66. For some discussion of the use of points in loans, see Charles W. Calomiris, Professor of Fin. & Econ., Columbia Bus. Sch., Testimony Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs: What to Do, and What Not to Do, About “Predatory Lending,” (July 26, 2001) [hereinafter Calomiris Testimony], reprinted in RICHARD SCOTT CARNELL, JONATHAN R. MACEY & GEOFFREY P. MILLER, *THE LAW OF BANKING AND FINANCIAL INSTITUTIONS* 380 (2009).

67. Mortgage Tips, *Pick-a-Default-or-a Foreclosure Mortgage*, BLOGCRITICS MAG., Oct. 6, 2006, at 1, 2, <http://blogcritics.org/archives/2006/10/06/1729592.php>.

68. *Id.*

69. *Id.* at 1.

70. See *supra* note 26 and accompanying text.

71. Alternatively, as home equity increases, a borrower may wish to enter into a home equity loan that is secured with a second lien on the mortgaged property.

estate prices that allowed subprime mortgage borrowers to avoid the high floating rates ended.⁷² A concurrent downturn in the economy as a whole and the fact that borrowers were switched from the fixed-rate “teaser” part of their loans to the high floating rates made delinquencies inevitable. The foreclosure rate throughout the United States continues to rise to levels that have not been seen in decades.⁷³ As a result of foreclosure, the equity that individuals had built up in their homes has dramatically disappeared. The fact that delinquencies and foreclosures have come in waves has had a dramatic impact on payouts from CMOs and CDOs, causing large financial institutions to reassess their risk and write-down securities to the tune of hundreds of billions of dollars, virtually destroying the market for these products.⁷⁴ Investors started to notice that the AAA rated mortgage-backed securities were much more risky than previously assumed, leading many to blame the rating agencies for inappropriately sanctioning the purchase of these securities.⁷⁵ The collateral effects of foreclosure even include worries about theft of materials from foreclosed homes⁷⁶ and West Nile virus-laden mosquitoes around abandoned swimming pools.⁷⁷ Much of the crisis has been attributed to a lack of understanding of the complex features of subprime mortgages and securitization.⁷⁸

In contrast, traditional mortgage financing was done by people who planned to repay the mortgage from their own earnings and where the success of the transaction did not depend critically on either future real estate prices or on future interest rate movements. This is not the case with many mortgage loans today. In the complex mortgage financings that we have described above, particularly subprime “pick-a-pay” mortgages, the old stereotypes about mortgage loans are inapplicable. Many borrowers, whether they knew it or not, could not afford to stay in their houses unless interest rates declined and real estate prices remained stable or increased, allowing them to refinance when initial “teaser” mortgage rates mushroomed out of control.

Moreover, many mortgage loans were made with little or no documentation provided by the borrowers about their income or credit history. These so-called “no doc” loans were (and are) made on the basis that they provide convenience for borrowers. As one loan originator put it, “[b]uyers that opt for a low doc home loan are typically those who prefer not to have their entire life and financial history presented to the lender. For instance, they might be using an inheritance to secure a loan or have fluctuating income

72. Sabry & Schopflocher, *supra* note 43, at 92–93.

73. See *Foreclosure Filings Up 121 Percent from Last Year*, MSNBC.COM, <http://www.msnbc.msn.com/id/25846164/> (last visited July 25, 2008); Les Christie, *January Foreclosures up 57%*, CNNMONEY.COM, Feb. 26, 2008, http://money.cnn.com/2008/02/26/real_estate/foreclosures_rise_again/index.htm?cnn=yes.

74. Nick Timiraos, *Why Banks' Pain Could Continue*, WALL ST. J., Jan. 19, 2008, at A11.

75. See, e.g., David Wessel, *Lessons from the Housing Bubble*, WALL ST. J., May 29, 2008, at A2 (stating that credit rating agencies played a critical role in overrating subprime mortgages that later resulted in a dramatic loss of investor confidence in securitized products).

76. Rusty Dornin, *Police Fight a Rash of Vacant Home Burglaries*, CNN.COM, July 22, 2008, <http://www.cnn.com/2008/CRIME/07/22/burglarized.foreclosures/index.html> (last visited Mar. 12, 2009).

77. *Foreclosures Lead to Abandoned Pools, Increased West Nile Risk*, KTVU.COM, Apr. 17, 2008, <http://www.ktvu.com/news/15908915/detail.html>.

78. “[T]he explosion of those complex investments may have gone too far because investors—big banks, insurers and others—never knew the real worth, or risk, their investments carried.” Timiraos, *supra* note 74.

from owning their own business.”⁷⁹ Of course, the reason lenders agreed to make loans without documentation is because the lenders were not looking to the borrowers’ income as the source of repayment for these loans: they, like the borrowers, foolishly were counting on real estate values to continue their ascent.

The inability of subprime borrowers to pay the interest on their mortgages, and the foreclosures that resulted, percolated through financial markets via mortgage-backed securities, collateral debt obligations, and other esoteric financial contracts. The resulting “credit crunch” stopped business lending in its tracks, ended Wall Street’s ability to employ leverage, and shut down a multibillion dollar industry, leaving investment banks scrambling to find buyers for illiquid, suddenly worthless securities. In 2008 Bear Stearns collapsed and was acquired by JPMorgan Chase,⁸⁰ the government infused massive amounts of capital into Fannie Mae and Freddie Mac,⁸¹ Bank of America purchased Merrill Lynch,⁸² Lehman Brothers filed for bankruptcy,⁸³ the government bailed out AIG

79. See Quicken Loans, No Doc Home Loans, <https://www.quickenloans.com/home-buying/learn/loans/no-doc-home-loans> (last visited Feb. 2, 2009).

80. See Edmond L. Andrews, *In Sweeping Move, Fed Backs Buyout and Wall St. Loans*, N.Y. TIMES, Mar. 17, 2008, at A1 (noting that in order to avoid a crisis in the financial markets, the Federal Reserve approved a \$30 billion credit line to facilitate the takeover of Bear Stearns); Neil Irwin & Tomoeh Murakami Tse, *Fed Comes To Rescue As Wall St. Giant Slips; Bear Stearns Gets Emergency Funds Via J.P. Morgan*, WASH. POST, Mar. 15, 2008, at A1 (discussing JPMorgan Chase’s acquisition of Bear Stearns involving emergency funding from the Federal Reserve); Robin Sidel, Dennis K. Berman & Kate Kelly, *J.P. Morgan Buys Bear in Fire Sale, As Fed Widens Credit to Avert Crisis—Ailing Firm Sold For Just \$2 a Share In U.S.-Backed Deal*, WALL ST. J., Mar. 17, 2008, at A1 (stating that Bear Stearns agreed to be sold to JPMorgan Chase for \$2 a share, or about \$236 million); Landon Thomas, Jr., *Run on Big Wall St. Bank Spurs Rescue Backed by U.S.*, N.Y. TIMES, Mar. 15, 2008, at A1 (describing the run on Bear Stearns which forced it to turn to the Federal Reserve for emergency funding). For a fascinating description of the fall of Bear Stearns and JPMorgan Chase’s acquisition of it, see Kate Kelly, Mike Spector & Randall Smith, *The Fall of Bear Stearns: Bear’s Final Moment: An Apology and No Lack of Ire*, WALL ST. J., May 30, 2008, at C1 (describing the stockholders’ vote to approve Bear’s sale to JPMorgan Chase and the chairman’s final comments); Kate Kelly, *The Fall of Bear Stearns: Bear Stearns Neared Collapse Twice in Frenzied Last Days—Paulsen Pushed Low-Ball Bid, Relented; a Testy Time for Dimon*, WALL ST. J., May 29, 2008, at A1 (describing how during the last few days of Bear Stearns’ existence, its stock spiraled downward, clients continued to flee, and trading partners left); Kate Kelly, *The Fall of Bear Stearns: Fear, Rumors Touched Off Fatal Run on Bear Stearns; Executives Swung from Hope to Despair in the Space of a Week*, WALL ST. J., May 28, 2008, at A1 (describing the week leading up to and the inner workings surrounding Bear’s receipt of emergency funding from the Federal Reserve).

81. See Zachary A. Goldfarb, David Cho & Binyamin Appelbaum, *Treasury to Rescue Fannie and Freddie; Regulators Seek to Keep Firms Troubles From Setting Off Wave of Bank Failures*, WASH. POST, Sept. 7, 2008, at A1 (stating that the federal government was prepared to take over Fannie Mae and Freddie Mac after it was clear they were unable to continue funding home mortgages); James R. Hagerty, Ruth Simon & Damian Paletta, *U.S. Seizes Mortgage Giants—Government Ousts CEOs of Fannie, Freddie; Promises up to \$200 Billion in Capital*, WALL ST. J., Sept. 8, 2008, at A1 (noting that the U.S. government took direct responsibility to provide the funding for three-quarters of new home mortgages); Neil Irwin & Zachary A. Goldfarb, *U.S. Seizes Control Of Mortgage Giants; Takeover of Fannie And Freddie Aims to Revive Housing, Financial Markets*, WASH. POST, Sept. 8, 2008, at A1 (stating that the government took control over Fannie Mae and Freddie Mac to restore faith in them and the economy); Stephen Labaton & Andrew Ross Sorkin, *U.S. Rescue Seen at Hand for Two Mortgage Giants*, N.Y. TIMES, Sept. 6, 2008, at A1 (noting that the federal government told Fannie and Freddie executives they were planning to take control of the companies).

82. See Eric Dash, *For Bank of America, Merrill’s Availability Was Rare Opportunity*, N.Y. TIMES, Sept. 16, 2008, at C9 (discussing Bank of America’s Chief Executive eyeing Merrill Lynch for takeover for months before it happened); Matthew Karnitschnig, Carrick Mollenkamp & Dan Fitzpatrick, *Bank of America to Buy Merrill*, WALL ST. J., Sept. 15, 2008, at A1 (noting that Merrill Lynch & Co. agreed to be sold to Bank of

to save it from insolvency,⁸⁴ Morgan Stanley and Goldman Sachs altered their corporate form to become bank holding companies rather than pure investment banks,⁸⁵ JPMorgan Chase bought Washington Mutual,⁸⁶ and Wells Fargo bought Wachovia.⁸⁷ The vast majority of these cataclysmic financial events occurred overnight, without warning or recourse for tens of thousands of Wall Street employees and investors. The government has been supremely involved, spearheaded by Treasury Secretary Henry Paulson's \$700 billion bailout plan.⁸⁸

Comparisons to the Great Depression are generally employed in explaining the sudden changes in market structure, available liquidity and leverage, and the monumental

America for \$50 billion to survive the financial crisis); Louise Story, *Stunning Fall for Main Street's Brokerage Firm*, N.Y. TIMES, Sept. 15, 2008, at A1 (describing the sale of Merrill Lynch and its implications for the history of Wall Street).

83. See Heather Landy, *Lehman Retools in Bid for Recovery; Investment Bank Loses \$3.9 Billion in Third Quarter*, WASH. POST, Sept. 10, 2008, at D1 (describing Lehman Brothers' announcement that it would sell a majority stake in its investment management unit in order to show that it can weather the credit crisis); Jeffrey McCracken, *Crisis on Wall Street: Lehman's Speedy Case—Fast Bankruptcy Leaves Little Time for Competing Bids*, WALL ST. J., Sept. 18, 2008, at C5 (noting that the Lehman Brothers sale was pushed fast and allowed little time for competing bids); Ben White & Eric Dash, *Barclays Reaches \$1.75 Billion Deal for Lehman Unit*, N.Y. TIMES, Sept. 17, 2008, at C1 (discussing Barclays's purchase of some core Lehman Brothers assets); Ben White & Michael M. Grynbaum, *The Street After Lehman Brothers*, N.Y. TIMES, Sept. 16, 2008, at C1 (noting the uncertainty and desperation in the last days before Lehman would down).

84. Edmund L. Andrews, Michael J. de la Merced & Mary Williams Walsh, *Fed in a \$85 Billion Rescue of an Insurer Near Failure*, N.Y. TIMES, Sept. 17, 2008, at A1 (describing the federal government's bailout of AIG); Matthew Karnitschnig et al., *U.S. to Take Over AIG in \$85 Billion Bailout*, WALL ST. J., Sept. 17, 2008, at A1 (discussing the government's seizure of AIG that signaled the danger of a financial system collapse).

85. See Jon Hilsenrath, Damian Paletta & Aaron Lucchetti, *Goldman, Morgan Scrap Wall Street Model, Become Banks in Bid to Ride Out Crisis—End of Traditional Investment Banking, as Storied Firms Face Closer Supervision and Stringent New Capital Requirements*, WALL ST. J., Sept. 22, 2008, at A1 (discussing Morgan Stanley and Goldman Sachs's change from investment banks to bank holding companies).

86. See Robin Sidel, David Enrich & Dan Fitzpatrick, *WaMu is Seized, Sold Off to J.P. Morgan, in Largest Failure in U.S. Banking History*, WALL ST. J., Sept. 26, 2008, at A1 (discussing the purchase of Washington Mutual by JPMorgan Chase).

87. The Wachovia purchase was somewhat marred by a legal battle between Citi and Wells Fargo. Citi agreed to purchase Wachovia's deposits for around \$2 billion and believed it had a deal. Wells Fargo offered a better deal, \$15.4 billion for Wachovia as a whole and without the government backstop that the Citi deal demanded. While Wachovia wanted the Wells Fargo deal, Citi claimed it had an agreement that could not be superseded. In the end, Wells Fargo won. See David Enrich & Dan Fitzpatrick, *Wachovia Chooses Wells Fargo, Spurns Citi—Deal Avoids Need for Taxpayer Cash; Pandit Vows a Fight*, WALL ST. J., Oct. 4, 2008, at A1 (discussing the fight between Wells Fargo and Citigroup over Wachovia); David Enrich & Matthew Karnitschnig, *Citi, U.S. Rescue Wachovia—Latest Shotgun Deal Creates Nation's Third-Largest Bank*, WALL ST. J., Sept. 30, 2008, at A1 (explaining, prior to the Wells Fargo bid, that Citigroup planned to take over Wachovia).

88. See Edmund L. Andrews, *Federal Reserve and Treasury Offer Congress a Plan for a Vast Bailout*, N.Y. TIMES, Sept. 19, 2008, at A1 (noting the discussions for the bailout to authorize the government to buy distressed mortgages); David Cho & Binyamin Appelbaum, *Historic Market Bailout Set in Motion; President Cites Urgent Need for Sweeping Intervention*, WASH. POST, Sept. 20, 2008, at A01 (discussing the proposed \$500 billion bailout of financial firms); David M. Herszenhorn, *Administration Is Seeking \$700 Billion for Wall Street in Possible Record Bailout*, N.Y. TIMES, Sept. 21, 2008, at A1 (describing the Bush Administration's formal bailout proposal); Deborah Solomon & Damian Paletta, *U.S. Bailout Plan Calms Markets, but Struggle Looms over Details*, WALL ST. J., Sept. 20, 2008, at A1 (describing the pressure on Congress to authorize the bailout); David Stout, *The Wall Street Bailout Plan, Explained*, N.Y. TIMES, Sept. 21, 2008, at A32 (attempting to identify and answer the questions Americans have about the Wall Street bailout).

sums of money investors and financial professionals have lost.⁸⁹ The role of subprime mortgage lending in the current crisis was played by stock speculation and bank runs during the Great Depression; the 1929 stock market crash and resulting bank run panic first altered the American financial picture, then led to a spate of regulation that has proved the backbone of the American financial system. The Securities Act of 1933,⁹⁰ the Securities Exchange Act of 1934,⁹¹ the FDIC,⁹² the SEC,⁹³ and countless other archetypal American financial institutions resulted from extreme market conditions and Congress's awareness of the untenability of Wall Street's practices. Our proposal to bring subprime mortgages under the aegis of the SEC is in the same vein.

III. SEC OVERSIGHT OF SUBPRIME MORTGAGE BROKERS

In this Part, we provide three independent bases under which the SEC might have control over subprime mortgage brokers. We begin with an argument that subprime mortgages differ substantially from prime mortgages and, as a result of their imbedded options and investment characteristics, can be classified as securities through the "notes" designation in the Securities Act of 1933 and the Securities Exchange Act of 1934. Second, we argue that the SEC should be able to regulate fraudulent actions of subprime mortgage brokers even in the absence of any securities classification of the subprime mortgages themselves because the subprime mortgages are made "in connection with the purchase and sale of" mortgage-backed securities. Under any of these plausible arguments, the SEC should have as much jurisdiction over subprime mortgage brokers as it does over securities broker-dealers.

A. Mortgages as Securities

In this section we make two claims. The first, with which we believe few would disagree, is that mortgages are *not* "investment contracts" for securities regulation purposes under the *Howey* test. We emphasize this fact to delineate the grounds we do

89. See, e.g., Jon Hilsenrath, Serena Ng & Damian Paletta, *Worst Crisis Since '30s, With No End Yet in Sight*, WALL ST. J., Sept. 18, 2008, at A1 (describing the damaging financial crisis that is continuing to grow beyond what was thought to be the original problem).

90. Securities Act of 1933, 15 U.S.C. §§ 77a–77aa (2006).

91. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78kk (2006).

92. The Federal Deposit Insurance Corporation insures demand deposits in FDIC banks up to \$250,000 per account. It was created in the aftermath of the bank runs that began the Great Depression. In exchange for FDIC protection, banks must have a certain percentage of deposit money in its hands at any time; as a result, the amount available for lending at any given time is less than the amount deposited by customers. Christopher M. Straw, *Unnecessary Risk: How the FDIC's Examination Policies Threaten the Security of the Bank Insurance Fund*, 10 N.Y.U. J. LEGIS. & PUB. POL'Y 395, 398–400 (2007); see also Daniel R. Fischel, Andrew M. Rosenfield & Robert S. Stillman, *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301 (1987); Jonathan R. Macey & Geoffrey P. Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153 (1988). The limit was recently increased from \$100,000 to \$250,000 for the remainder of 2009 in the wake of the financial crisis. See FDIC: Frequently Asked Question for Deposit Insurance, <http://www.fdic.gov/deposit/difaq.html> (last visited Mar. 21, 2009).

93. The SEC was created in 1934 as a result of the enactment of the Securities Exchange Act, section 4, 48 Stat. 881, 885 (1934) (codified at 15 U.S.C. § 78d). See *Exchange Bill Agreement Provides New 5-Man Board, Flexible Curb on Margins*, N.Y. TIMES, May 27, 1934, at 1 (announcing the passage of the Stock Exchange Regulation Bill and creation of the SEC).

and do not claim for inclusion of subprime mortgages under the SEC's aegis. Second, we argue that subprime mortgages, but not prime mortgages, are "notes" for securities regulation purposes under the *Reves* test.⁹⁴ To make this argument, we discuss the definition of "note" for 1933 and 1934 Act purposes, culminating with the test for notes espoused in the *Reves* case. We make the case that subprime mortgages and prime mortgages, often considered slight variations on the same theme, are entirely different in exactly those ways relevant to the *Reves* analysis.

We urge the reader, in reading this section, to resist the initial temptation to relegate all mortgages to the "nonsecurities" wastebasket simply because of precedent treating anything called a "mortgage" as a nonsecurity. In *United Housing Foundation, Inc. v. Forman*,⁹⁵ the Supreme Court clearly articulated that, for securities law purposes, the economics of a transaction govern, not the name given to the contract:

We reject at the outset any suggestion that the present transaction, evidenced by the sale of shares called "stock," must be considered a security transaction simply because the statutory definition of a security includes the words "any . . . stock." Rather we adhere to the basic principle that has guided all of the Court's decisions in this area: "[I]n searching for the meaning and scope of the word 'security' in the Act[s], form should be disregarded for substance and the emphasis should be on economic reality."⁹⁶

Much like a financial transaction is not a security simply because it carries the name of the security,⁹⁷ a transaction that (especially only colloquially) carries a name of a historical nonsecurity, like a subprime mortgage, should not be dismissed without a true economic analysis of its substance.

The gateway to securities regulation under the federal securities laws is the definition of "security" in section 2(a)(1) of the 1933 Act, while essentially the same definition is used in the 1934 Act:

The term "security" means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities

94. See *infra* note 103 and accompanying text (discussing the *Reves* test).

95. *United Housing Found., Inc. v. Forman*, 421 U.S. 837 (1975).

96. *Id.* at 848 (footnote omitted) (quoting *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967)).

97. Of course, the label isn't completely irrelevant.

In holding that the name given to an instrument is not dispositive, we do not suggest that the name is wholly irrelevant to the decision whether it is a security. There may be occasions when the use of a traditional name such as "stocks" or "bonds" will lead a purchaser justifiably to assume that the federal securities laws apply. This would clearly be the case when the underlying transaction embodies some of the significant characteristics typically associated with the named instrument.

Id. at 850–51. Our claim, however, is that the label is not the end of the inquiry.

exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.⁹⁸

Regulation of subprime mortgages as securities would require pigeonholing them as either "investment contracts" or "notes."

"Investment contract" is the catch-all for things that walk and talk like a security but do not fit into any of the other categories. Indeed, a large number of cases involving whether a specific instrument is or is not a security come down to whether a specific financial transaction is an investment contract. The four-part test for what constitutes an investment contract was provided by the Supreme Court in 1946 in the *Howey* case: "[A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person [1] invests his money in a [2] common enterprise and is [3] led to expect profits [4] solely from the efforts of the promoter or a third party . . ." ⁹⁹ Since *Howey*, this test has been used to categorize a number of transactions as investment contract securities under the SEC's watch, including some franchises,¹⁰⁰ membership plans,¹⁰¹ and even animal breeding contracts.¹⁰²

Mortgages of any type, including subprime mortgages, seem unlikely to qualify as investment contracts under the *Howey* test definition. First, they are not common enterprises; mortgage contracts generally involve one borrower and, at least at inception, one lender. Second, mortgage borrowers do not invest in mortgage contracts with the expectation of monetary profits. Third, there are no third-party efforts to change the value of the mortgage; the mortgage value is only changed by interest rate fluctuations and changes in real estate values. Thus, we do not believe that the SEC has jurisdiction over subprime mortgages as investment contracts.

The fact that a subprime mortgage is not an investment contract does not mean it is not a security. Analyzing subprime mortgages as "notes" is more fruitful. Interestingly, the Supreme Court has explicitly stated that the investment contract analysis is irrelevant to the decision of whether a financial contract is a note:

We reject the approaches of those courts that have applied the *Howey* test to notes; *Howey* provides a mechanism for determining whether an instrument is an "investment contract." The demand notes here may well not be "investment contracts," but that does not mean they are not "notes." To hold that a "note" is not a "security" unless it meets a test designed for an entirely different variety of instrument "would make the Acts' enumeration of many types of instruments superfluous," and would be inconsistent with Congress' intent to regulate the entire body of instruments sold as investments.¹⁰³

98. 15 U.S.C. § 77b(a)(1) (2006).

99. SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946).

100. See 2 LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, SECURITIES REGULATION 996–1002 (4th ed. 2006) (giving examples of when the *Howey* test has been applied to franchises).

101. See *id.* at 1003–11 (showing that membership plans have been characterized as investment contracts).

102. Including, for example, foxes, oysters, muskrats, rabbits, chinchillas, beavers, pigs, and cows. See *id.* at 958 n.193.

103. *Reves v. Ernst & Young*, 494 U.S. 56, 64 (1990) (quoting *Landreth Timber Co. v. Landreth*, 471 U.S.

Thus, we treat our analysis of subprime mortgages as notes separate from that of subprime mortgages as investment contracts.

Prior to 1990, the federal circuits split a number of ways on the question of what particular aspects of indebtedness contracts make them “notes” for securities purposes. The Second Circuit followed the “family resemblance test,”¹⁰⁴ presuming that a note is a security but checking whether the note is similar to one of a number of exceptions, in which mortgage notes are included without explanation. The First, Third, Fifth, Seventh, and Tenth Circuits followed the so-called “investment/commercial dichotomy test,”¹⁰⁵ which categorized notes financing investments as securities and those financing commercial goods as not securities.¹⁰⁶ Under this rubric, standard prime mortgages were considered consumption, rather than investment, goods and thus the notes financing them were not considered securities. The Supreme Court’s decision in *Reves v. Ernst & Young* favored the Second Circuit’s test, but noted that “the ‘family resemblance’ and ‘investment versus commercial’ tests . . . are really two ways of formulating the same general approach.”¹⁰⁷

Under the *Reves* test, a court’s determination of whether a specific note evidencing debt is a “note” for securities law purposes is informed by four factors.¹⁰⁸ First, incorporating the investment/commercial divide discussed above, the test looks at whether buyers enter into the transaction for consumption or investment purposes.¹⁰⁹ A note evidencing a debt purely for commercial purposes, like a note behind the financing of a washing machine, is not a security. Second, the test looks at the mode of distribution of the financial contract.¹¹⁰ Third, the *Reves* test asks whether the public considers the investment to be a security; public perception of whether there should be some sort of regulation is important.¹¹¹ Finally, the test asks whether there is another regulatory scheme in place to deal with the financial contract in question.¹¹²

Our strongest arguments for treating subprime mortgages as notes involve the first and fourth *Reves* factors. First, we believe that some mortgages have crossed the line between financial vehicles used to finance personal consumption (which are not securities) and financial instruments with significant investment components that should be categorized as notes regardless of the fact that there is a consumption component involved.¹¹³ Recall the discussion above of the refinancing and default options held by mortgage borrowers. The importance of the imbedded options should not be understated. Indeed, many subprime mortgage brokers convinced borrowers to accept loans with high

681, 692 (1985)).

104. 2 LOSS, SELIGMAN, & PAREDES, *supra* note 100, at 882.

105. *Id.* at 870–74.

106. Other tests, not relevant to our discussion here, are the Ninth Circuit’s “risk capital test,” *id.* at 874–78, and the Eighth and D.C. Circuit’s use of the *Howey* test. *Id.* at 882.

107. *Reves*, 494 U.S. at 64.

108. *Id.* at 66–67.

109. *Id.* at 66.

110. *Id.*

111. *Id.*

112. *Reves*, 494 U.S. at 67.

113. It is quite common for financial instruments that involve a significant consumption component to qualify as securities. Vacation time-shares are one such example. *See Teague v. Bakker*, 35 F.3d 978, 990 (4th Cir. 1994) (suggesting that timeshare offerings are sometimes subject to the securities laws).

floating rates after two years, promising that they would be able to refinance before the end of the fixed “teaser” period. These borrowers entered into these mortgages *precisely because* of their imbedded options. Unfortunately, the past few months have proven that the default option is as valuable, if not more, than the refinancing option.

It is true that prime mortgages have the same imbedded options as subprime mortgages, but the importance of these options in prime mortgages pales in comparison with the importance of the options in subprime mortgages, due to differences in the volatility of the underlying income stream and the “moneyness,” or implicit value, of each option. As with all financial options, the imbedded mortgage options increase in value when the volatility of the underlying security increases. Thus the mortgage is worth more in the subprime case, where the income stream of the borrower is more volatile, than in the prime case. Options with little likelihood of being exercised—those that are “out of the money”—are worth far less than those that are likely to be exercised. Prime mortgage borrowers are very unlikely to default on their homes, as evidenced by their credit histories. In addition, refinancing due to small changes in interest rates is far more likely for subprime borrowers who have floating mortgages tied to interest rates than for prime borrowers with fixed mortgage payment rates. These facts conspire to make the options imbedded in subprime loans relevant to borrowers and those imbedded in prime loans not relevant, as evidenced by the larger number of subprime borrowers who default and refinance. As such, the former designation of all mortgages, which includes these investment-like subprime mortgages, as outside the realm of securities regulation is no longer valid. Further supporting this contention is the fact that many modern mortgage instruments were issued in refinancing transactions in which borrowers “borrowed big for a house and then refinanced to pull out cash.”¹¹⁴

It is important to emphasize our exact purpose in discussing the financial options imbedded in the subprime mortgages: we use these options not to say that the subprime mortgages are securities because they are just a bundle of options, but instead because the importance of the options favors an interpretation of subprime mortgages as investments rather than pure consumption under the *Reves* test. It is true that financial options are only under the SEC’s jurisdiction if they are written on defined securities, but this is not the purpose of introducing their importance. The fact that the borrower (and not the originator) holds the options lends credence to the idea that even though the borrower is making the intermittent payments, he is the holder of the security and the originator is its issuer.

The second *Reves* factor asks about the method of distribution of the financial contract “to determine whether it is an instrument in which there is ‘common trading for speculation or investment.’”¹¹⁵ Similar to the first *Reves* factor, the method of distribution of mortgages has changed over time in favor of a “notes” categorization, particularly for subprime mortgages. Based on data collected from a number of sources, Gary Gorton found that 80.5% of subprime mortgages were securitized in 2006.¹¹⁶ Securitization transactions involve a number of financial trades of the mortgage contract

114. *Bubble*, *supra* note 1.

115. *Reves*, 494 U.S. at 66 (quoting *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943)).

116. Gary B. Gorton, *The Panic of 2007*, at 20 (Yale Int’l Ctr. for Fin., Working Paper No. 08-24, 2008), available at <http://www.kc.frb.org/publicat/sympos/2008/gorton.08.04.08.pdf>.

and the cash flows emanating from it. Mortgage borrowers do not generally trade their mortgages; at the same time there is certainly more of a secondary market related to the mortgage contract now than there was (even for prime mortgages) when the securities acts were enacted.

The third *Reves* factor explores the “reasonable expectations of the investing public.”¹¹⁷ If the public believes a specific note is a security, it is more likely to be treated as such and afforded the appropriate protections under the securities laws. Subprime borrowers, who generally have a lower level of financial literacy than prime borrowers, are more likely to believe that their transactions with mortgage brokers and originators are under some sort of government oversight and protection, such as the suitability inquiry discussed below.¹¹⁸ Thus, a stronger case can be made for subprime mortgages under this prong of the test than for prime mortgages.

Significant support for our position can be found within the fourth *Reves* factor, which looks at whether another system exists through which the government regulates the notes in question. This had been a central tenet of “notes as securities” jurisprudence before *Reves*; the Supreme Court held in *International Brotherhood of Teamsters v. Daniel* that certain types of pension plans are not securities due to their coverage by ERISA.¹¹⁹ As Loss, Seligman and Paredes write, “[t]he pivotal factor . . . was federal regulation that served the same investor protection purpose as the federal securities laws.”¹²⁰ There is no particular federal agency with oversight of mortgages, and certainly no group with particular responsibility for subprime mortgages. The Home Ownership and Equality Protection Act of 1994 (HOEPA), the Community Reinvestment Act (CRA), the Equal Credit Opportunity Act (ECOA), and the Fair Housing Act (FHA) form a regulatory morass in which no particular entity has the ability to fix the predatory subprime problem.¹²¹ For sure, no regulatory system as comprehensive as ERISA exists.

117. *Reves*, 494 U.S. at 66.

118. See, e.g., Ruth Simon, *Debating Standards for Mortgage Lenders*, WALL ST. J., Mar. 8, 2007, at D1 (explaining a proposed suitability requirement); *infra* Part IV (discussing the suitability rule).

119. *Int'l Brotherhood of Teamsters v. Daniel*, 439 U.S. 551, 569–70 (1979).

120. 2 LOSS, SELIGMAN & PAREDES, *supra* note 100, at 864.

121. This is not a paper on predatory lending and, as such, we do not spend a great deal of time on the subject. However, a footnote discussing some of the main issues in predatory lending may prove helpful. Predatory loans are those which originators and brokers use to take advantage of borrowers who may be incapable of understanding the terms of their loan or may be coerced into entering loans that are not in their best interest. See CARNELL ET AL., *supra* note 66, at 370–96. Terms or practices that are unnecessary given the borrower's financial situation, or that are unduly onerous or difficult to repay, are predatory. *Id.*

It is important to recognize that subprime lending and predatory lending are not the same. Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37,569, at 37,571 (July 10, 2007) [hereinafter Subprime Statement]; Engel & McCoy, *supra* note 3, at 1261; Cassandra Jones Havard, *To Lend or Not to Lend: What the CRA Ought to Say About Sub-Prime and Predatory Lending*, 7 FL. COASTAL L. REV. 1, 2 (2005). However, legitimate subprime loans and predatory loans share a number of common terms, blurring the line between the two.

There are a number of laws protecting against predatory lending. The Truth in Lending Act (TILA) is a disclosure statute that requires lenders to provide certain information to borrowers such as: financing charged, the annual percentage yield (APR) of the loan, and the total cost of the loan. The hope is that this disclosure will allow borrowers to make informed decisions about the financial contracts they enter into. 15 U.S.C. §§ 1601–1665, 1671–1677 (2006). Regulation Z, 12 C.F.R. 226 (2008), implements TILA. On TILA generally, see COMPTROLLER OF THE CURRENCY ADMIN. OF NAT'L BANKS, TRUTH IN LENDING: COMPTROLLERS HANDBOOK (2006), available at <http://www.occ.treas.gov/handbook/til.pdf>. The Home Ownership and Equity Protection

Thus, labeling subprime mortgages “securities,” and affording them regulation by the SEC, does not step on the toes of other governmental entities.

Subprime mortgage borrowers span a spectrum from those taking out the mortgage loans specifically to live in the purchased homes (or refinancing to improve the homes they own) to those purchasing homes as pure speculative investments. Public policy and individual empathy generally favor the first class, those hard-working individuals cursed with poor credit who entered into mortgages they could not repay. It is tempting to consider these mortgage borrowers pure consumers of housing and the speculators as pure investors, which might militate towards defining subprime mortgages as securities only in the hands of speculators. This result is at odds with what we are trying to achieve. Yet, two facets of the subprime mortgage market make this counterargument erroneous. First, the subprime mortgage borrowers who live in their homes are taking out the subprime mortgage as an investment—they choose to put their money into homes rather than spending it on rent, which is pure consumption. While society generally approves of this investment, it is an investment nonetheless and is a risky one due to the possibility of loss of equity through foreclosure. Second, as we will discuss below, our primary purpose in arguing for SEC regulation of subprime mortgage brokers is the imposition of a duty of suitability on these parties. Suitability explicitly takes the financial expertise of the purchaser/borrower into account and only provides remedies for those needing protection. As a result, even if all subprime mortgages were classified as securities the SEC would have a tool that can only be used to help the defenseless subprime mortgage borrower, not the speculator. As a result, classifying subprime mortgages as securities because of their investment characteristics only helps the subprime mortgage borrower we want to put back in a home, and does not reward the speculator whose bet has gone bad.

In this section, we did not argue that, as originally conceived, the securities laws

Act of 1994 (HOEPA), 15 U.S.C. § 1639 (2006), defines a class of loans known colloquially as “high-cost” refinancing loans and includes both disclosure and substantive requirements for such loans. *Id.* Substantively, brokers and originators cannot include in HOEPA “high-cost” loans prepayment penalties, negative amortization terms, and balloon payments, and cannot make the loans based solely on collateral. *Id.* However, since HOEPA requirements do not come into play until the “high-cost” triggers are hit, and very few loans actually hit those triggers, critics have argued that it is not strong enough. Weiner, *supra* note 56, at 553–54; *Predatory Mortgage Lending: The Problem, Impact, and Responses: Hearing on the Federal Home Loan Bank System Before the S. Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2001) (Statement of Martin Eakes, President & CEO, Self-Help Credit Union) [hereinafter Eakes Testimony]. The Community Reinvestment Act (CRA), 12 U.S.C. §§ 2901–2906 (2006), seeks to stop “redlining,” the process of giving loans only to those in upscale and nonminority areas, *id.*, by requiring banks to obtain certain number of “credits” for working in low-income and predominantly minority areas. The Fair Housing Act (FHA) prohibits discrimination in housing transactions. 42 U.S.C. § 4601 (2006). See Andrew L. Sandler et al., *The Expansion of Liability for Predatory and Discriminatory Lending to Secondary Mortgage Market Participants*, in UNDERSTANDING COMPLEX FINANCIAL INSTITUTIONS 2007, at 821, 826 (2007). The Equal Credit Opportunity Act (ECOA) does the same for lending. 15 U.S.C. § 1691 (2006). Closing costs and their disclosure are regulated by the Real Estate Settlement Procedures Act (RESPA). 12 U.S.C. §§ 2601–2617 (2006). See Hammond, *supra* note 49, at 186 (explaining the required disclosures under RESPA); Wilson, *supra* note 22, at 1498 (2005) (describing some criticisms of the RESPA disclosure requirements). In sum, subprime mortgages are subject to a regulatory morass, even the most direct elements of which barely scratch the surface of current concerns. The system would be easier, and more effective, if mortgages were regulated securities under the watch of the SEC.

were meant to cover mortgages used to purchase homes or make improvements to them. The framers of the Securities Act of 1933, the Securities Exchange Act of 1934, and the SEC saw as their purpose the regulation of volatile stock markets and the risky securities peddled by brokers. Whether or not mortgages would have been explicitly included in the list of regulated securities if the securities laws were written today remains open for debate. Yet, we argue that subprime mortgages are securities as defined in the Securities Act of 1933 and the Securities Exchange Act of 1934, in particular under the category of "notes." Subprime mortgages are in large part investments, either as first-lien or equity refinancing mortgages, have no comprehensive regulatory oversight, and contain imbedded options critical to their purchase.

B. Mortgage Transactions "In Connection With" Purchases and Sales of Securities

Our second argument for SEC regulation of subprime mortgage brokers depends not on the characterization of the mortgage itself, but on its securitization. Due to the securitization process's work in turning subprime mortgages into traded securities, we believe the mortgage origination itself is a transaction "in connection with the purchase or sale of any security."¹²² As noted above, the central antifraud provision found in the federal securities law, section 10(b) of the Securities Exchange Act of 1934, forbids "any person" from using "in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors."¹²³ The SEC's Rule 10b-5 makes it unlawful for "any person . . . to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."¹²⁴

The phrase "in connection with the purchase or sale of any security" has been interpreted extremely broadly. For example, under the so-called misappropriation theory, when a lawyer or an investment banker trades on the basis of nonpublic, confidential information obtained from clients, the lawyer or banker has violated Rule 10b-5. This is a violation even though the person deceived or defrauded (the client) is not the person involved in the trading and even though the lawyer or banker owes no duty of any kind to the counter-party with whom he or she is trading.¹²⁵ One does not have to be a lawyer or investment banker to be subject to the so-called fiduciary duties that give rise to Rule 10b-5 standards of care. People such as overnight delivery workers, messengers, independent contractors, limousine drivers, and shoe shiners all either have been held or are thought subject to the provisions of SEC Rule 10b-5.¹²⁶ It seems beyond doubt that

122. This is true, of course, only where the mortgage is actually part of a securitization. A plaintiff arguing for SEC oversight on these grounds would have to prove that his particular mortgage was sold as part of a securitization transaction. However, since an overwhelming majority actually are, we are not currently concerned with this requirement. See Gorton, *supra* note 116, at 20 (providing a chart of mortgage origination and subprime securitization, which shows the importance of subprime securitizations).

123. 15 U.S.C. § 78j (2006).

124. 17 C.F.R. § 240.10b-5 (2008). For the full text of Rule 10b-5, see *supra* note 11.

125. *United States v. O'Hagan*, 521 U.S. 642 (1997).

126. *Richard W. Painter et al., Don't Ask, Just Tell: Insider Trading After United States v. O'Hagan*, 84 U. VA. L. REV. 153, 214 (1998).

the relationship between a mortgage broker and a home buyer is far closer to a classic fiduciary relationship than the relationship between somebody with confidential information about securities prices and the person who shines that person's shoes or drives that person around in a town car.

Similarly, it seems clear to us that maneuvering an unsuspecting client into taking on an unsuitable mortgage, on which the borrower is bound to default unless interest rates stay low and housing prices stay high so that the mortgage can be refinanced, is done in connection with the purchase and sale of a security, where all parties understand that the payments being made on the mortgage are an integral part of a securitization. Thus, even if a mortgage itself is not a security, where the mortgage is used as part of a securitization, that transaction is done in connection with the purchase or sale of a security and the protections of Rule 10b-5 should protect the borrower.¹²⁷ Similarly, there appears to be little distinction between cases in which a mortgage broker convinces a person to refinance in order to purchase securities (where Rule 10b-5 clearly applies), and cases in which a mortgage broker convinces a person to refinance so that the mortgage broker himself can participate in the creation of a new security.¹²⁸

This argument seems to expand the role of the SEC dramatically by arguing for antifraud liability over anything securitized into an instrument over which the SEC has authority. Credit card receivables, student loans, and music licensing payments are often securitized and traded on the secondary market, yet it is hard to imagine the underlying transaction as under the SEC's purview. However, the scope of our argument is limited in two important ways. First, our claim that subprime mortgages should be treated as arising "in connection with the purchase or sale of a security" does not mean that the SEC will have plenary power over subprime mortgages, but instead that fraudulent actions by brokers in these transactions could be prosecuted by the SEC under section 10(b) and Rule 10b-5. This should mollify those worried about SEC domination of all financial transactions. Second, the securities laws axiom that the SEC should not intervene where Congress has created a comprehensive regulatory system, discussed above in reference to the *Reves* test, provides an important check on the SEC's ability to claim securitized transactions as under even its antifraud jurisdiction.

In the next Part we will examine the principal legal protections that would be available to borrowers if the securities laws extended their coverage to include subprime mortgages, either directly through the definition of a subprime mortgage as a security or swap agreement, or through the argument that subprime mortgages are created as part of a securitization chain. In our view, the available protections are substantial. The fact that borrowers have not been able to avail themselves of these protections is unfortunate.

IV. SUITABILITY

What would securities oversight of mortgages mean? An important protection for people who transact in the securities market, and the one we feel most relevant to mortgages, is what is known as the "suitability rule." This requires that broker-dealers recommend only those financial products that are suitable for a particular customer. We

127. We pause to note the existence of, but cannot discuss in detail, securitizations of credit card receivables.

128. See generally Complaint, *supra* note 4.

call this type of suitability “product suitability” as it focuses on the product itself and the attributes of the product that bear on the risk held by the client. In addition, suitability also applies to the manner in which securities are financed and the process by which a securities transaction is structured. We use the term “transaction form suitability” to refer to this aspect of the suitability doctrine. The fact that the form of a transaction, as well as the financial instrument being traded in the transaction, must be suitable further supports our argument that the suitability principle should be applied in the context of mortgage marketing as well as securities marketing.

A. Suitability in the Securities Context

The doctrine of suitability requires that broker-dealers only recommend to their clients those financial transactions that are suitable given the customer’s level of financial sophistication, current investments, financial status, personal circumstances, and anything else that might bear on the client’s ability to accept the risks associated with a particular investment.¹²⁹ The suitability doctrine requires broker-dealers to tailor the securities sold to a customer with that customer’s specific financial needs and objectives, and forbids agents from simply pushing those products that offer the greatest profit margins for the seller.

The suitability doctrine arose from some of the same concerns that led Congress to pass the Securities Act of 1933¹³⁰ and the Securities Exchange Act of 1934,¹³¹ namely fears about unsophisticated investors taken advantage of by financially savvy (and unscrupulous) professionals. These concerns certainly resonate in the subprime mortgage industry today. One practice particularly targeted by suitability was the so-called “boiler room,” which consisted of pressured phone calls urging the investor to buy risky securities, without any concern for their suitability.¹³² Today, like in the 1930s, most actions against broker-dealers for suitability and suitability-like violations involve sad stories of elderly and/or infirm individuals swindled by unscrupulous broker-dealers.¹³³

Historically, broker-dealers have been federally liable for ensuring suitability under

129. Charles R. Mills, Benjamin J. Oxley & Ronald A. Holinsky, *Customer Transactions: Suitability, Unauthorized Trading, and Churning*, in *BROKER-DEALER REGULATION* § 6:1.2 (Practising Law Inst. 2008).

130. Securities Act of 1933, 73 Pub. L. 22, 48 Stat. 74 (1933) (codified as amended at 15 U.S.C. §§ 77a–77aa (2006)).

131. Securities Exchange Act of 1934, 73 Pub. L. 291, 48 Stat. 881 (1934) (codified as amended at 15 U.S.C. §§ 78a–78kk (2006)).

132. See *SEC v. Hasho*, 784 F. Supp. 1059, 1061 (S.D.N.Y. 1992); *Greenberg*, 40 S.E.C. 133 (1960) (discussing cases where broker-dealers make unsuitable recommendations to their customers regarding investments).

133. The story of Lottie Balasko is typical.

Balasko was seventy-one years old and recovering from a debilitating stroke when Bruce Blevins approached [J. Stephen] Stout about opening an investment account for his great-aunt. Balasko received a fixed income from social security and pension checks. She relied on investment income to cover her living expenses, including 24-hour home health care. Her prognosis was uncertain. Despite Balasko’s clear need for income and liquid investments that could readily be converted into cash, Stout purchased illiquid limited partnership securities for Balasko’s account.

J. Stephen Stout, Exchange Act Release No. 43,410, 73 SEC Docket 1081 (Oct. 4, 2000). For another sad story, see Rafael Pinchas, Exchange Act Release No. 41,816, 70 SEC Docket 1180 (Sept. 1, 1999) (describing a broker’s unsuitable recommendations and excessive trading on a client’s account).

three sets of overlapping, though not identical, rules.¹³⁴ The first set, promulgated by the National Association of Securities Dealers (NASD), is found in NASD Conduct Rule 2310. That rule provides that:

(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

(b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:

- (1) the customer's financial status;
- (2) the customer's tax status;
- (3) the customer's investment objectives; and
- (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.¹³⁵

The New York Stock Exchange (NYSE) suitability requirement, known colloquially as the "Know Thy Customer Rule" for its biblical incantations requiring a broker-dealer to know his customer's financial situation, states that members must:

Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization.¹³⁶

Self-regulatory organizations (SROs) like the NASD and NYSE may discipline their members for violations of the stated rules, including suitability.¹³⁷ However, it is unclear

134. There are also requirements under state laws. *See, e.g.,* Taylor v. First Jersey Sec., Inc., 533 So. 2d 1383 (La. Ct. App. 1988) (causes of action alleged for violations of Louisiana securities laws); *see also* JERRY W. MARKHAM & THOMAS LEE HAZEN, 23A BROKER-DEALER OPERATIONS UNDER SECURITIES AND COMMODITIES LAW § 10:12 (2007) (discussing suitability requirements under state law); *see* NORMAN S. POSER, BROKER DEALER LAW AND REGULATION § 3.03 (3d ed. 2001).

135. Fin. Indus. Regulatory Auth., FINRA Manual: NASD Rule 2310 (2008), *available at* http://finra.complinet.com/finra/display/display.html?rbid=2403&record_id=4315&element_id=3638&highlight=2310#r4315.

136. Fin. Indus. Regulatory Auth., FINRA Manual: NYSE Rule 405(1) (2008), *available at* http://rules.nyse.com/NYSETools/ExchangeViewer.asp?selectednode=chp_1_5_7_7&manual=%2Fnyse%2Fnyse_rules%2Fnyse-rules%2F. While the NASD and most elements of the NYSE combined in July of 2007 to form the Financial Industry Regulatory Authority (FINRA), the doctrine of suitability developed prior to this combination and, as a result, we will continue to refer to the NASD and NYSE separately. FINRA has adopted the NASD rule provided above, and as a result the doctrine is still also relevant in practice.

137. Many, though not all, SROs have suitability requirements for their members. The Commodities Futures Trading Commission (CFTC), as an example, does not, though one was considered. *See Bieganek v. Wilson*, 642 F. Supp. 768, 773 (N.D. Ill. 1986) (noting that the CFTC "apparently did not adopt a rule defining [the suitability requirement] because it could not develop 'meaningful standards' of universal application").

whether the SRO suitability rules imply a private right of action; most authority on the matter assumes they do not, though there are some cases to the contrary.¹³⁸ Therefore, while SROs may discipline or remove members for violating these rules, there seems to be no way for wronged individuals to recover from broker-dealers who suggested an unsuitable investment.¹³⁹

However, the SEC and federal courts have found broker-dealers personally liable for suitability violations under section 10(b) of the Securities Exchange Act and SEC Rule 10b-5,¹⁴⁰ under which private rights of action are implied.¹⁴¹ The underlying legal theory

Some claim that the CFTC does not need an explicit suitability requirement because one is implied in other rules. *See id.* (discussing the CFTC's deliberations over suitability); POSER, *supra* note 134, § 3.03 (same).

138. Compare *Jablon v. Dean Witter & Co.*, 614 F.2d 677 (9th Cir. 1980) (finding no private right of action), and *Thompson v. Smith Barney, Harris Upham & Co.*, 539 F. Supp. 859 (D. Ga. 1982), *aff'd*, 709 F.2d 1413 (11th Cir. 1983) (finding against plaintiff under the theory that NASD and NYSE suitability rules contain no private right of action), with *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178 (2d Cir. 1966) (finding that, under certain circumstances, there can be private actions under SRO rules). *See also* MARKHAM & HAZEN, *supra* note 134, § 10:10 (arguing that there is no private right of action for violation of SRO rules); Mills et al., *supra* note 129, § 6, at 6-1, § 6:1.4, at 6-24 (arguing that there is no private right of action for violation of SRO rules). Other cases stand for the proposition that there are causes of action for unsuitability where additional elements, akin to the Rule 10b-5 elements discussed *infra*, are present. *See, e.g.*, *Buttrely v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir. 1969) (allowing a claim under NYSE Rule 405 when the conduct is tantamount to fraud); *Rolf v. Blyth Eastman Dillon & Co.*, 424 F. Supp. 1021, 1040-43 (S.D.N.Y. 1977) (finding that there can be a private right of action where there is fraud and scienter). Yet other cases avoid the question of private rights of action under the SRO rules completely by switching to a Rule 10b-5 paradigm. *See Clark v. John Lamula Investors, Inc.*, 583 F.2d 594 (2d Cir. 1978) (holding that the defendants violated Rule 10b-5 and that the required scienter was present).

139. There appears to be one case in which, regardless of the existence of a private right of action, the defendant asked the court to view their conduct under the NASD suitability rule. *McQuesten v. Advest, Inc.*, Civ. A. No. 83-1302-MC-A, 1988 WL 125783, at *3 (D. Mass. Aug. 4, 1988).

140. Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2006), states that:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5, 17 C.F.R. § 240.10b-5 (2008), states that

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

- a. To employ any device, scheme, or artifice to defraud,
 - b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
 - c. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
- in connection with the purchase or sale of any security.

The two are the dominant rules under which courts find liability for fraud in securities transactions.

for finding a violation of Rule 10b-5 for selling an unsuitable security is that when recommending an inappropriate security to a customer the defendant either provided misleading information or omitted to state a material fact to the investor, both of which are actionable under Rule 10b-5 as currently interpreted.¹⁴² Some courts distinguish between misrepresentation/omission liability and liability by actual conduct, known as the "fraud by conduct" theory.¹⁴³ One of the first cases to find suitability liability under a Rule 10b-5 theory was *Clark v. John Lamula Investors, Inc.*,¹⁴⁴ in which the court decided that the question of a private right of action under the NASD suitability rule was irrelevant because the unsuitability alleged was a violation of section 10.¹⁴⁵

The elements required to find a suitability violation under Rule 10b-5 differ from those under SRO rules. Suitability liability under SEC Rule 10b-5 is described most clearly in the case of *Brown v. E.F. Hutton Group, Inc.*¹⁴⁶ In that case, the court found:

A plaintiff must prove (1) that the securities purchased were unsuited to the buyer's needs; (2) that the defendant knew or reasonably believed the securities were unsuited to the buyer's needs; (3) that the defendant recommended or purchased the unsuitable securities for the buyer anyway; (4) that, with scienter, the defendant made material misrepresentations (or, owing a duty to the buyer, failed to disclose material information) relating to the suitability of the securities; and (5) that the buyer justifiably relied to its detriment on the defendant's fraudulent conduct.¹⁴⁷

There are important differences between the *Brown* court's statement of the Rule 10b-5 suitability requirement and the SRO suitability rules discussed above, all of which have been affirmed by later courts. First, there is an explicit recommendation requirement, which is in accordance with the NASD rule but not the NYSE rule.¹⁴⁸ Second, a Rule 10b-5 determination of unsuitability requires a finding of scienter, common to all Rule 10b-5 violations as a result of the Supreme Court's ruling in *Ernst &*

141. See *Superintendent of Ins. of State of N.Y. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 13 n.9 (1971) (citing 6 LOUIS LOSS, *SECURITIES REGULATION* 3869-73 (1969)); 5B ARNOLD S. JACOBS, *DISCLOSURE AND REMEDIES UNDER THE SECURITIES LAWS* § 6:15 (2008). While there is a private right of action under Rule 10b-5 for suitability violations, at least one court has found that suitability cannot be alleged through class action because the requirements are too individualized to give rise to a common class. See *Rowe v. Morgan Stanley Dean Witter*, 191 F.R.D. 398 (D.N.J. 1999) (illustrating a case where investors brought a class action alleging churning, unsuitable trades, and unauthorized trades).

142. See, e.g., *Rolf v. Blyth Eastman Dillon & Co.*, 424 F. Supp. 1021, 1036-37 (S.D.N.Y. 1977) (discussing the legal theory in this case for alleged violations of Rule 10b-5); J. Stephen Stout, Exchange Act Release No. 43,410, 73 SEC Docket 1081 (Oct. 4, 2000) (holding the former salesman of a registered broker-dealer liable for a civil money penalty for engaging in unsuitable and unauthorized trading and making fraudulent statements and material omissions in connection with the offer and sale of securities); J. Stephen Stout, Exchange Act Release No. 43,410, 73 SEC Docket 1094 (Oct. 4, 2000) (imposing sanctions on Stout).

143. See 6 ALAN R. BROMBERG & LEWIS D. LOWENFELS, *BROMBERG & LOWENFELS ON SECURITIES FRAUD AND COMMODITIES FRAUD* § 13:186, at 13-472 (2d ed. 2008) (discussing private damage actions for unsuitability).

144. *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594 (2d Cir. 1978).

145. "Because we find that the jury's findings support a judgment of violation of § 10 of the Securities Exchange Act, we need not decide whether the NASD Rules create an independent cause of action." *Id.* at 599.

146. *Brown v. E.F. Hutton Group, Inc.*, 991 F.2d 1020 (2d Cir. 1993).

147. *Id.* at 1031.

148. See *supra* text accompanying notes 135-36 (discussing the NASD and NYSE Rules).

*Ernst v. Hochfelder*¹⁴⁹ but not mentioned by the SRO rules.¹⁵⁰ Some courts have found that “recklessness” satisfies the suitability scienter requirement,¹⁵¹ though this is not settled.¹⁵² Third, the scienter must relate to either a “misrepresentation or material omission”¹⁵³ coupled with a duty to disclose such information. This “misstatement/omission” theory of fraud liability is prevalent in Rule 10b-5 jurisprudence. Some courts, however, have instead found liability under a “fraudulent conduct” theory, under which certain conduct of broker-dealers is itself fraudulent.¹⁵⁴ Finally, Rule 10b-5 unsuitability requires that the customer rely on the omission or misstatement.¹⁵⁵ For these reasons it is more difficult for private plaintiffs to successfully assert a violation of suitability under a Rule 10b-5 theory than for SROs or the SEC to do so under SRO rules.

A number of statutes and judicial rulings connect the Rule 10b-5 and SRO suitability rules more closely than initially seems apparent. In particular, the same courts that hear alleged violations of Rule 10b-5 suitability hear suitability cases under the guise of SRO appeals, and much of the doctrine of suitability laid down by courts originated from alleged violation of SRO rules.¹⁵⁶ In addition, the various forms of suitability have been somewhat substantively combined by courts. In *Miley v. Oppenheimer & Co., Inc.*,¹⁵⁷ the Fifth Circuit held that the NASD and NYSE rules could be used in helping to determine whether Rule 10b-5 had been violated.¹⁵⁸

The existence of rules ensuring suitability is meant to be an *ex ante* protection against improper investment,¹⁵⁹ not a way for investors to recoup losses from investing

149. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

150. See *O'Connor v. R.F. Lafferty & Co.*, 965 F.2d 893 (10th Cir. 1992); *Clark v. John Lamula Investors, Inc.*, 583 F.2d 594 (2d Cir. 1978); J. Stephen Stout, Exchange Act Release No. 43,410, 73 SEC Docket 1081 (Oct. 4, 2000).

151. See *O'Connor*, 965 F.2d at 899 (“Therefore, in our test for unsuitability a plaintiff must show the broker purchased the securities with an intent to defraud or with reckless disregard for the investor’s interests.”).

152. POSER, *supra* note 134, § 3.03 (discussing that this remains an unclear proposition).

153. See, e.g., *Woodruff v. Merrill Lynch, Pierce, Fenner & Smith*, No. CV88-L-314, 1989 WL 224581, at *4 (D. Neb. July 14, 1989).

154. *O'Connor*, 965 F.2d at 898 (although fraudulent conduct was not found on the part of defendants in this case, the court discusses “fraud by conduct”); POSER, *supra* note 134, § 3.03.

155. See *O'Connor*, 965 F.2d at 898 (explaining the requirement of reliance on the misstatement).

156. For some examples of cases that originated as SRO rules, see *Krull v. SEC*, 248 F.3d 907 (9th Cir. 2001) (reviewing alleged violation of the NASD Rule of Fair Practice); *Weendell D. Belden*, Exchange Act Release No. 47,859, 80 SEC Docket 563 (May 14, 2003) (reviewing an alleged violation of NASD suitability rule); *Jack H. Stein*, Exchange Act Release No. 47,335, 79 SEC Docket 1777 (Feb. 11, 2003) (reviewing alleged violation of NASD suitability rule); *Harry Gliksman*, Exchange Act Release No. 42,255, 71 SEC Docket 767 (Dec. 20, 1999) (reviewing an alleged violation of NASD suitability rules); *Rafael Pinchas*, Exchange Act Release No. 41,816, 70 SEC Docket 1108 (Sept. 1, 1999) (reviewing an alleged violation of NASD suitability rules); *Timoleon Nicholaou*, Exchange Act Release No. 34,454, 57 SEC Docket 639 (July 28, 1994) (reviewing an alleged violation of NYSE suitability rule); *Gerald M. Greenberg*, Exchange Act Release No. 6320, 40 SEC 133 (July 21, 1960) (reviewing an alleged violation of NASD suitability rules).

157. *Miley v. Oppenheimer & Co.*, 637 F.2d 318 (5th Cir. Unit A Feb. 1981).

158. *Id.* at 333; see also *O'Connor*, 965 F.2d at 898 (citing *Miley*, 637 F.2d at 318; *Hotmar v. Lowell H. Listrom & Co.*, 808 F.2d 1384, 1385–86 (10th Cir. 1987)).

159. “[T]he focus of this suitability claim is not whether the customers made money, but whether [transactions] served a reasonable investment objective when made.” *Krull*, 248 F.3d at 913.

in securities with full knowledge of, and ability to handle, the attendant risks.¹⁶⁰ Clients who are financially sophisticated and well-versed in the particular securities involved are generally unsuccessful in asserting a suitability claim,¹⁶¹ because the sophistication of the investor is a "critical factor" in determining whether there is a material omission or misstatement under a Rule 10b-5 assertion of unsuitability.¹⁶²

Courts are sometimes willing to find nonfinancial professionals "sophisticated" enough to forestall a suitability claim where the person is otherwise educated and follows the stock market carefully.¹⁶³ The generally recognized sophistication exception to suitability recognizes that the broker-dealer should only be held liable where the unsuitability of the recommended investment comes, in part, from the inability of the investor to understand its risks. Where a transaction involves complex securities, however, "sophistication" requires both general financial sophistication and sophistication in the specific security implicated.¹⁶⁴

Another limitation on the suitability requirement is that a broker-dealer can only be held liable in cases where he actually recommended the transaction in question to his client.¹⁶⁵ The NASD suitability rule looks at broker-dealers' obligations "[i]n recommending to a customer the purchase, sale or exchange of any security."¹⁶⁶ To allay any doubt, NASD Notice to Members 96-60 states that "[a] member's suitability obligation under Rule 2310 applies only to securities that have been recommended by the member."¹⁶⁷ However, "recommendation" can be read broadly, enhancing liability to cases where the broker-dealer simply made the client aware of a potential transaction.¹⁶⁸

160. "The scenario of the disappointed—but not defrauded—investor, who tries to recover his loss through means of the federal securities laws, has become all too common in the federal courts." *Gleit v. Shearson, Hammill & Co.*, No. 74 Civ. 4082, 1976 WL 847, at *1 (S.D.N.Y. Oct. 20, 1976); *see also* *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bockock*, 247 F. Supp. 373, 373 (S.D. Tex. 1965) (arguing that the purpose of suitability is not to help those who knowingly availed themselves of risk).

161. *See* *Padgett v. Dapelo*, 826 F. Supp. 99, 100 (S.D.N.Y. 1993) (explaining that educational background is an important factor in deciding whether the client was "fleeced").

162. *Banca Cremi, S.A. v. Alex. Brown & Sons, Inc.*, 132 F.3d 1017, 1028 (4th Cir. 1997) (quoting the eight factors to look at as described in *Myers v. Finkle*, 950 F.2d 165, 167 (4th Cir. 1991)).

163. *See* *Rolf v. Blyth Eastman Dillon & Co.*, 424 F. Supp. 1021, 1026-27 (S.D.N.Y. 1977) (finding a doctor to be sophisticated where the doctor followed securities' prices carefully and often changed the brokerage firms he used).

164. *See* NASD Rule 2310-3 (2008), available at http://finra.compliner.com/en/display_main.html?rbid=2403&element_id=3641 ("The two most important considerations in determining the scope of a member's suitability obligations in making recommendations to an institutional customer are the customer's capability to evaluate investment risk independently and the extent to which the customer is exercising independent judgment in evaluating a member's recommendation.").

165. *See* *Grosso v. Salomon Smith Barney*, No. 03-MC-115, 2003 WL 22657305 (E.D. Pa. Oct. 24, 2003) (finding no liability under NYSE and NASD suitability rules where there was no recommendation by the broker-dealer); *J.W. Barclay & Co.*, Exchange Act Release No. 239, 81 SEC Docket 1156 (Oct. 23, 2003) (finding a recommendation as a precursor to finding liability); *see also* *Mills et al.*, *supra* note 129, § 6:1.2[E], at *6-9.

166. *Fin. Indus. Regulatory Auth.*, FINRA Manual: NASD Rule 2310 (2008), available at http://finra.complinet.com/en/display_main.htm?rbid=2403&element_id=3638 (emphasis added).

167. *Fin. Indus. Regulatory Auth.*, FINRA Manual: NASD, Notice to Members 96-60, Clarification Of Members' Suitability Responsibilities Under NASD Rules with Special Emphasis on Member Activities in Speculative and Low-Priced Securities 473 (Sept. 1996), available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=1774.

168. The Notice provides that a "transaction will be considered to be recommended when the member or its

The recommendation requirement is broadly, but not universally, observed;¹⁶⁹ and the recommendation requirement appears to be losing its potency over time.¹⁷⁰

Further limiting the scope of the "recommendation" requirement is the doctrine that broker-dealers cannot recommend, and subsequently help customers engage in, unsuitable transactions even if all risks are disclosed to the customer and the customer still requests to become involved in the transaction.¹⁷¹ The SEC has stated that "[a]s a fiduciary, a broker may only make recommendations that are in the best interests of his customer, even when the recommendations contradict the customer's wishes."¹⁷² Thus, "the test for whether [a broker-dealer's] recommended investments were suitable is not whether [the client] acquiesced in them, but whether [the broker-dealer's] recommendations to [the client] were consistent with her financial situation and needs."¹⁷³ Similarly, a broker-dealer cannot recommend a transaction that is appropriate for a goal stated by the customer if the goal is not suitable for the customer's financial situation; for example, even if a customer asks the broker-dealer for a transaction that maximizes the probability of doubling in value, the broker-dealer cannot recommend a speculative security that maximizes this probability if that security is not suited to the customer's financial situation.¹⁷⁴

The existence and extent of an obligation of broker-dealers to inquire into the financial status of a customer for suitability has been a matter of debate. The NYSE "Know Thy Customer Rule" is most direct in this regard, requiring the broker-dealer to "learn the essential facts relative to every customer."¹⁷⁵ Suitability doctrines apply even in a broker-dealer's interactions with institutional investors.¹⁷⁶ The suitability doctrine is quite encompassing and is meant not only to protect the weak, uninformed, or penniless, but also to provide a counterbalance to the informational asymmetry inherent in complex financial interactions and dissuade those with the capability from using those

associated person brings a specific security to the attention of the customer through any means, including, but not limited to, direct telephone communication, the delivery of promotional material through the mail, or the transmission of electronic messages." *Id.* at 474 (emphasis removed).

169. BROMBERG & LOWENFELS, *supra* note 143, § 13:186, at 13-436.

170. See Frederick Mark Gedicks, *Suitability Claims and Purchases of Unrecommended Securities: An Agency Theory of Broker-Dealer Liability*, 37 ARIZ. ST. L.J. 535, 540-43 (2005) (discussing the obligation of full-service broker-dealers to be aware of novice investors' investment objectives and financial situation in order to make investment recommendations that are suitable to the customers' needs).

171. See Jack H. Stein, Exchange Act Release No. 47,335, 79 SEC Docket 1777 (Feb. 11, 2003), 2003 WL 431870, at *2 (noting that registered representatives fail to satisfy the suitability requirement "simply by disclosing the risk of an investment" and, in fact, have a "duty to refrain from making recommendations that are incompatible with the customer's financial profile").

172. See POSER, *supra* note 134, § 3.03[A][1], at 3-85.

173. Jack H. Stein, Exchange Act Release No. 47,335, 79 SEC Docket 1777 (Feb. 11, 2003), 2003 WL 431870, at *4.

174. "[E]ven if Wang had desired Pinchas to double her money, that desire would not have relieved Pinchas from his duty to recommend only those trades suitable to her situation." Pinchas, Exchange Act Release No. 41,816, 70 SEC Docket 1108 (Sept. 1, 1999), 1999 WL 680044, at *6.

175. NYSE, Inc., NYSE Rule 405(1), available at http://rules.nyse.com/NYSETools/ExchangeViewer.asp?selectednode=chp_1_5_7_7&manual=%2Fnyse%2Fnyse_rules%2Fnyse-rules%2F.

176. See NASD Rule 2310-3, *supra* note 164; see also MARKHAM & HAZEN, *supra* note 134, § 10:4; Mills et al., *supra* note 129, § 6:1.3[B], at 6-11; POSER, *supra* note 134, § 3.03[A][1], at 3-83. Note, however, that the inquiry requirement of Rule 2310(b) only applies to noninstitutional customers. BROMBERG & LOWENFELS, *supra* note 143, § 13:188, at 13-444.

informational asymmetries to their advantage. Clearly these protections would have provided a significant deterrent to those brokers aggressively peddling subprime mortgages.

B. Product vs. Transaction Suitability

The vast majority of cases interpreting suitability consider the term “suitable transaction” to mean “suitable security” and focus solely on whether the security in question fits the financial needs of the customer. The issue in the vast majority of suitability cases is whether a broker-dealer recommended a product to a client with attributes that were inappropriate for the client’s risk tolerance. We refer to this strand of suitability as “product suitability” to emphasize the product-based nature of the inquiry.

To determine appropriately whether a specific security is suitable for a specific customer, a broker-dealer must look at both the risk profile of the customer in question and the risk distribution of the security in question.¹⁷⁷ A high volatility, low-priced stock is unsuitable for an elderly individual on fixed income who relies on that fixed income for living expenses.¹⁷⁸ This same security, however, might be appropriate for a young investor with disposable income who can weather the storm of volatility. Similarly, of course, certain securities are suitable for even an elderly person on a fixed income.

Suitability requirements scale up as the relevant securities become more complex, both within and between exchanges. For example, the Chicago Board of Options Exchange requires a more thorough suitability analysis than do many other SROs because of the increased complexity of the securities offered on that exchange.¹⁷⁹ Suitability requirements sometimes vary within the same SRO based on the complexity and risk of the relevant security. Examples in the NYSE and NASD context include strict suitability requirements on day trading, penny stocks, and variable annuities.¹⁸⁰ Sales of shares of hedge funds have received specific attention, even though one might assume that those with the money (or accredited investor status) to invest in hedge funds are sophisticated enough to determine whether such an investment is suitable.¹⁸¹

177. See, e.g., Gedicks, *supra* note 170, at 547–49 (defining “suitability,” “customer-specific suitability,” and “reasonable-basis suitability” in relating the duty of broker-dealers to make required evaluations prior to issuing their recommendations).

178. See POSER, *supra* note 134, § 3.03[A][1], at 3-80 (offering several examples where individual characteristics of customers, both known and unknown to the broker-dealer, influence the suitability of various investments).

179. See Mills et al., *supra* note 129, § 6:1.3, at 6-10 (acknowledging that “there are a number of specialized suitability principles or requirements that apply in particular contexts or to particular types of securities”); POSER, *supra* note 134, § 3.03[A][2], at 3-88 (commenting on the more stringent suitability requirements of the Chicago Board Options Exchange).

180. Mills et al., *supra* note 129, § 6:1.3[D][1], [F], [G], at 6-13–6-21; POSER, *supra* note 134, § 3.03. For a description of variable annuities, see U.S. Sec. & Exch. Comm’n, Variable Annuities, <http://www.sec.gov/answers/varann.htm> (last visited Feb. 1, 2009).

181. NASD, Notice to Members 03-07, NASD Reminds Members of Obligations When Selling Hedge Funds 47, 50 (2003), available at http://www.finra.org/web/groups/rules_regs/documents/notice_to_members/p003358.pdf (stating that “[a] customer’s specific level of assets does not, by itself, satisfy a member’s obligations under the suitability rule”); see also Mills et al., *supra* note 129, § 6:1.3[H].

C. Transaction Form Suitability

While suitability is usually discussed in terms of the match between the investor and the actual securities recommended by broker-dealers, the requirement goes further. Professors Mills, Oxley and Holinsky write:

The suitability doctrine generally applies to all aspects of a securities transaction that might affect the appropriateness of a recommended transaction for a customer. Thus, the doctrine has been applied to challenge transactions as unsuitable based on excessive market risk relative to the customer's risk tolerance and objectives, excessive transaction costs, excessive margin financing and other factors that could affect the investment return from the transaction.¹⁸²

Broker-dealers are required not only to provide suitable products to their customers; they are also required to provide those products under purchase conditions that are suitable to the customers' financial know-how, situation, and investment goals. Since this notion of suitability focuses on the form of the transaction rather than the products themselves, we refer to it as "transaction form suitability." Such protections would have been particularly valuable in the subprime mortgage market because such financial instruments frequently were sold without regard to the financial know-how, individual financial situation, or the investment goals of the customers buying them.

Courts and commentators have not formally recognized the distinction we are seeking to draw between product and transaction suitability. But the distinction clearly exists as evidenced by the fact that transactions have been ruled to be unsuitable despite the fact that the securities themselves were suitable for the customer. Thus, even if an investor requests specific securities with full knowledge of the attendant risks, a broker-dealer can be held liable for selling such securities under the unsuitability doctrine.¹⁸³ In *J.W. Barclay & Co.*, the SEC noted that "[w]hile a suitability inquiry often focuses on whether a particular security is appropriate for an investor, the Commission has stated that the frequency of trading must be suitable, as well."¹⁸⁴ The Southern District of New York in *Rolf v. Blyth Eastman Dillon & Co.* found that a broker "must satisfy himself that not only the security but also the type of transaction is suitable for the customer."¹⁸⁵

Theoretically, any aspect of the purchase or sale of a security implicates the transaction form suitability requirements and serves to constrain broker-dealers' marketing efforts. The basic tenet is that broker-dealers cannot enter into transactions that cost more for investors but provide them no additional benefit.¹⁸⁶ In the next three

182. Mills et al., *supra* note 129, § 6:1.2, at 6-4.

183. For example, the SEC:

takes the position that the NASD rule is violated even where the broker makes an unsuitable recommendation in response to the customer's expressed wish to speculate in the market. As a fiduciary, a broker may only make recommendations that are in the best interests of his customer, even when the recommendations contradict the customer's wishes.

POSER, *supra* note 134, § 3.03[A][1], at 3-85.

184. *J.W. Barclay & Co.*, Initial Decision Release No. 239, 81 SEC Docket 1156 (Oct. 23, 2003), 2003 WL 22415736, at *30.

185. *Rolf v. Blyth Eastman Dillon & Co.*, 424 F. Supp. 1021, 1042-43 (S.D.N.Y. 1977).

186. See, e.g., Wendell D. Belden, Exchange Act Release No. 47,859, 80 SEC Docket 563 (May 14, 2003)

subsections we focus on three types of transaction suitability approaches that appear particularly relevant in the mortgage context: margin purchases, transaction frequency, and commission structure.

1. Suitability in Margin Purchases

Purchasing securities “on margin” simply means borrowing some portion of the purchase price from the broker-dealer when buying securities.¹⁸⁷ If securities bought on margin appreciate in value, this gain is used to pay the broker-dealer for the initial purchase and the purchaser owns more of the securities than he would have been able to by purchasing the securities for full price. If the securities decline in value, however, a “margin call” occurs and the buyer must find the money elsewhere to restore the collateral position of the lender. In other words, margin purchases allow the use of leverage to increase both the risks and the rewards associated with the purchase of a security.

The purchase of securities on margin is regulated by the Federal Reserve,¹⁸⁸ which requires that at least 50% of the initial purchase of a security be paid up front,¹⁸⁹ though individual broker-dealers and exchanges may require more.¹⁹⁰ While the Federal Reserve does not require continuing margin payments after initial purchase of the securities, the NYSE and NASD (and now FINRA) each require that member firms adopt a 25%

(finding unsuitable a transaction in which Class B shares of a corporation were purchased that provided no additional benefit to investors beyond Class A shares, but were more expensive and led to increased payments to the broker-dealer).

187. See Federal Reserve System, 63 Fed. Reg. 2806, 2809 (Jan. 16, 1998) (codified at 12 C.F.R. pts. 207, 220, 221, 224 and 265). For more on margin purchasing, see Fin. Indus. Regulatory Auth., *Purchasing on Margin, Risks Involved with Trading in a Margin Account*, <http://www.finra.org/Investors/SmartInvesting/AdvancedInvesting/MarginInformation/P005927> (last visited Jan. 29, 2009).

188. 12 C.F.R. § 220.8 (2008). The Federal Reserve has promulgated Regulation T under authority delegated in section 7 of the Securities and Exchange Act of 1934, which provides, in part:

For the purpose of preventing the excessive use of credit for the purchase or carrying of securities, the Board of Governors of the Federal Reserve System shall, prior to October 1, 1934, and from time to time thereafter, prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security (other than an exempted security or a security futures product).

15 U.S.C. § 78g(a) (2006).

The Board shall prescribe, or, if the authority is delegated pursuant to subparagraph (A)(ii), the Commission and the Commodity Futures Trading Commission shall jointly prescribe, such regulations to establish margin requirements, including the establishment of levels of margin (initial and maintenance) for security futures products under such terms, and at such levels, as the Board deems appropriate, or as the Commission and the Commodity Futures Trading Commission jointly deem appropriate

15 U.S.C. § 78(c)(2)(B).

189. See Federal Reserve System, 63 Fed. Reg. 2809; see also Simon Kwan, *Margin Requirements as a Policy Tool?*, FRBSF ECON. LETTER (Fed. Reserve Bank of S.F., S.F., Cal.), Mar. 24, 2000, <http://www.frbsf.org/econsrch/wklyltr/2000/el2000-09.html>.

190. See Fin. Indus. Regulatory Auth., *Margin Disclosure Statement*, <http://www.finra.org/web/groups/investors/@inv/@smart/@advanc/documents/investors/p005895.pdf> (last visited Feb. 2, 2009) (noting that brokerage firms provide a separate margin agreement when stocks are traded in margin accounts).

"maintenance margin requirement."¹⁹¹ Interestingly, no restrictions whatsoever exist to limit the leverage available to people who engage in mortgage financings.

The SEC, SROs, states, and individual broker-dealers have all created rules relating to the terms and disclosure upon which margin purchases must be based. SEC Rule 15c2-5¹⁹² requires that credit be offered from broker-dealers to customers (in situations where the credit requirements of Regulation T are not invoked) only after "[d]eliver[ing] to such person a written statement setting forth the exact nature and extent of . . . such person's obligations under the particular loan . . . the risks and disadvantages which such person will incur . . . [and] all commissions, discounts, and other remuneration received" and "[o]btain[ing] from such person information concerning his financial situation and needs, reasonably determin[ing] that the entire transaction, including the loan arrangement, is suitable for such person, and retain[ing] in his files a written statement setting forth the basis upon which the broker or dealer made such determination."¹⁹³ Rule 10b-16 requires the broker-dealer, prior to buying securities for a customer on margin and quarterly after buying such securities, to provide a plethora of information to the customer.¹⁹⁴ A model statute advocated by the North American Securities Administrators Association, adopted by 45 American jurisdictions, considers it "per se" negligent for a broker-dealer to "execut[e] any transaction in a margin account without securing from the customer a properly executed written margin agreement promptly after the initial transaction in the account."¹⁹⁵ Essentially all broker-dealers require a signed statement from investors representing that the investor understands and wishes to engage in margin transactions before an individual agent is allowed to trade for an account on margin. In short, margin purchasing is risky and, as a result, is heavily regulated.

There have been a number of cases asserting unsuitability under SRO rules and Rule 10b-5 related to purchases of securities on margin.¹⁹⁶ A common fact pattern recurs in

191. *Id.*

192. 17 C.F.R. § 240.15c2-5 (2008).

193. *Id.*

194. Rule 10b-16, 34 Fed. Reg. 19,717, 19,718 (Dec. 16, 1969); *see also* CHARLES F. RECHLIN, SECURITIES CREDIT REGULATION 3:74, at 3-107 (2d ed. 2008) (describing the large amount of disclosure required when customers wish to trade on margin).

195. NORTH AM. SECS. ADM'RS ASS'N, MODEL RULE DISHONEST OR UNETHICAL BUSINESS PRACTICES OF BROKER-DEALERS AND AGENTS § 1(f) (1983).

196. In addition to the *Canady* case discussed in detail below, *see DelPorte v. Shearson, Hammill & Co.*, 548 F.2d 1149, 1153 (5th Cir. 1977) ("The margin account, in light of the circumstances surrounding the investment needs and objectives of the Plaintiff, was unsuitable for the Plaintiff."); *Troyer v. Karcagi*, 476 F. Supp. 1142, 1152 (S.D.N.Y. 1979) ("The opening or maintenance of an unsuitable margin account, without disclosure of the unsuitability to the client, renders a brokerage house primarily liable if that brokerage house acts with scienter and knowingly or recklessly fails to disclose that unsuitability."); *Steven E. Muth*, Securities Act Release No. 8622, Exchange Act Release No. 52,551, 86 SEC Docket 956 (Oct. 3, 2005) ("Muth increased the risks to these customers by recommending that they purchase these speculative securities on margin."); and *J.W. Barclay & Co.*, Exchange Act Release No. 239, 81 SEC Docket 1156, 1176 (Oct. 23, 2003) ("Opening a margin account or making a margin trade in a customer's account may constitute unsuitable trading in violation of the antifraud provisions of the securities laws if the account executive knowingly or recklessly fails to disclose the risks of margin trading."). *See also* Mills et al., *supra* note 129, § 6:1.2[B], at 6-6 (noting that "a registered representative could breach his or her suitability obligations by recommending . . . that a customer with an objective of long-term capital appreciation use significant margin loans to purchase securities, where the customer lacks adequate financial means to meet margin calls other than through liquidation of the stock, because a short-term decline in the stocks could force sales and consequently large losses"). Of course, buying

these cases: investors with conservative investment profiles open up margin accounts for trading and lose a great deal of money when the securities drop in price and margin calls are made. In most, if not all, of these cases, the investor did not understand margin financing and its entailed risks.¹⁹⁷ At least one court has recognized that even a signed document allowing the broker-dealer to engage in margin transactions is not enough to shield a broker-dealer from suitability liability where the investor did not understand the document or appreciate its risk significance.¹⁹⁸ As in securities suitability generally, margin suitability claims generally require that the broker-dealer recommended the transaction.¹⁹⁹ In addition, the sophistication of investors is germane to whether they are capable of comprehending the risks of margin purchasing such that broker-dealers are not liable for the investor's decision to use margin.²⁰⁰ Despite these restrictions, we believe that the margin-related suitability rules would map quite well onto current problems in the mortgage industry.

Laurie Jones Canady is illustrative of margin suitability cases in the securities context.²⁰¹ Canady, who worked at broker-dealer Merrill Lynch, managed accounts for four testifying investors, three of whom professed conservative investment goals and one of whom did not discuss investment goals with Canady.²⁰² Cynthia Christianson Sim's account with Canady was funded by death benefits from her husband's death and was meant to provide income to help care for her children, a conservative investment goal.²⁰³ Yet Canady wrote on Sim's account that her goals were "speculative investments" and bought securities for Sim on margin without informing her.²⁰⁴ Canady encouraged Carolyn Campbell to open an account with the money she obtained from her husband's life insurance; she "sought 'income' through 'investment grade' and 'good quality' investments."²⁰⁵ Yet Canady invested Campbell's money in high-yield risky securities

on margin is not per se unsuitable. See *Gleit v. Shearson, Hammill & Co.*, Fed. Sec. L. Rep. (CCH) ¶ 95,799 (S.D.N.Y. Oct. 20, 1976).

197. See, e.g., *J. Stephen Stout*, Exchange Act Release No. 43,410, 73 SEC Docket 1081, 1094 (Oct. 4, 2000); *Laurie Jones Canady*, Exchange Act Release No. 41,250, 69 SEC Docket 1169 (Apr. 5, 1999), 1999 WL 183600; *Timoleon Nicholaou*, Exchange Act Release No. 34,454, 51 SEC 1215, 1217, 1220 (July 28, 1994).

198. See *Timoleon Nicholaou*, Exchange Act Release No. 34,454, 51 SEC 1215, 1217 (July 28, 1994).

199. See *Grosso v. Barney*, No. 03-MC-115, 2003 WL 22657305, at *8 (E.D. Pa. Oct. 24, 2003) (considering a suitability claim under NYSE and NASD suitability rules and finding no liability because the investors chose to go on margin without a recommendation to do so). However, the fact that the investors at one time purchased securities on margin does not give the broker-dealer license to make further purchases on margin. See *Steven E. Muth*, Securities Act Release No. 8622, Exchange Act Release No. 52,551, 86 SEC Docket 956, 966 (Oct. 3, 2005) ("Muth claims that the investments were suitable for these customers because they had previously purchased Creative Host and/or Bonso on margin. This fact did not give Muth a license to disregard his customers' current financial situation or investment objectives. Muth failed to fulfill his responsibility to ensure that his customers, on a current basis, fully understood the risks involved and were both able and willing to take those risks.").

200. *Xaphes v. Merrill Lynch Pierce Fenner & Smith, Inc.*, 632 F. Supp. 471, 481-82 (D. Maine 1986) ("John Xaphes was a highly educated, financially sophisticated investor at all times pertinent to this litigation. . . Plaintiff was similarly well suited to trading on margin.").

201. *Laurie Jones Canady*, Exchange Act Release No. 41,250, 69 SEC Docket 1169 (Apr. 5, 1999), 1999 WL 183600.

202. *Id.* at *1.

203. *Id.* at *2-*3.

204. *Id.* at *3.

205. *Id.* (quoting Campbell's writing on her account form).

and did so on margin.²⁰⁶ Evelyn Fasbender, a nonworking widow, invested a modest life-savings of \$38,000 with Canady, yet Canady amassed what at one time was a \$48,000 margin account debt on Fasbender's account.²⁰⁷ Finally, Mary Gruhl controlled an account managed by Canady meant to provide income to her and her disabled husband with "nothing but conservative investments".²⁰⁸ In actuality, Canady populated the account with margin transactions.²⁰⁹ None of the four investors were sophisticated in financial matters, none understood margin trades, and Canady deflected inquiries regarding account statements with, as Gruhl testified, pronouncements "'not to worry; that things were going fine'" and that "'she was taking care of [the accounts]'".²¹⁰

The SEC upheld the findings of an administrative judge that Canady violated section 17(a) of the Securities Act of 1933,²¹¹ section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 through these actions.²¹² The SEC's finding relied heavily on a suitability theory of the inappropriate nature of margin trading for these clients. According to the SEC, "Canady knew that her excessive use of margin in the accounts of the Testifying Customers was unsuitable in light of their stated conservative investment objectives."²¹³ The SEC refused to credit Canady's argument that she should not be liable for suitability violations because the customers each signed documents allowing her to trade their accounts on margin, finding that "while [they] may have signed forms put in front of them, [they] did not know that, by doing so, they had agreed to engage in margin trading. Canady then gave these customers a false sense of security by misleading them regarding the adverse impact of margin trading on their accounts."²¹⁴ Furthermore, the fact that the customers qualified for margin trading under Merrill Lynch's internal controls that, as Canady pointed out, were stricter than the federal law requirements, did not mean that margin trading was suitable for them.²¹⁵ Margin suitability is not about the legal ability to engage in transactions and the law does not generally provide a safe harbor; instead suitability is about the propriety of engaging in transactions.

206. Laurie Jones Canady, Exchange Act Release No. 41,250, 69 SEC Docket 1169 (Apr. 5, 1999), 1999 WL 183600, at *3.

207. *Id.* at *4.

208. *Id.* at *5.

209. *Id.* at *5 (quoting Mary Gruhl).

210. *Id.* at *2–*5 (quoting Canady's comments to the investors).

211. Section 17(a) of the Securities Act has language that closely tracks that of section 10(b) of the Securities Exchange Act, 15 U.S.C. § 10(b) (2006). In particular, section 17(a) says:

It is unlawful for any person in the offer or sale of any securities . . . (1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

15 U.S.C. § 17(a) (2006).

212. Laurie Jones Canady, Exchange Act Release No. 41,250, 69 SEC Docket 1169 (Apr. 5, 1999), 1999 WL 183600, at *1. Canady was also held liable under these statutes and rules for churning her customers' accounts. For ease of exposition, we do not discuss the churning claims here and save a discussion of churning for the next section.

213. *Id.* at *8.

214. *Id.*

215. *Id.*

2. Suitability in Excessive Trading: Churning

The second form of transaction implicated in suitability litigation is frequent trading, which is similar to the securities industry's "churning." Broker-dealers are usually remunerated through commissions on each trading transaction. As a result, the income of a broker-dealer is directly tied to the number of transactions he effects for his clients, and an unscrupulous broker-dealer can increase his income by encouraging customers to engage in more trades than are in the customers' best interests.²¹⁶

Excessive trading is usually analyzed as an occurrence of churning, a long-held Rule 10b-5 theory under which excessive trading in an account as a whole is a violation of the antifraud statute,²¹⁷ regardless of the nature and description of the underlying securities. The court in *Mihara v. Dean Witter & Co.* provided a canonical three-part test for a churning violation:

In order to establish a claim of churning, a plaintiff must show (1) that the trading in his account was excessive in light of his investment objectives; (2) that the broker in question exercised control over the trading in the account; and (3) that the broker acted with the intent to defraud or with the wilful and reckless disregard for the interests of his client.²¹⁸

The first *Mihara* element sounds in suitability theory and the third sounds in Rule 10b-5 theory more generally. The third is not always expressed as part of suitability theory but has been in certain cases.²¹⁹

Some circuits cling to a securities product suitability paradigm and therefore see churning as a transaction infraction and suitability as a product attribute matching problem.²²⁰ In other cases, the SEC has made it clear that excessive trading is itself a

216. As the Southern District of New York put it:

Since brokers are traditionally compensated by commissions in direct proportion to purchases and sales, the opportunity to take advantage of the client is always present. To ensure that the broker fulfills his fiduciary duty, and to protect against frauds upon the customer, the broker and his employer are made subject to a series of obligations, the fraudulent breach of which may render them liable to the investor in damages.

Rolf v. Blyth Eastman Dillon & Co., 424 F. Supp. 1021, 1036 (S.D.N.Y. 1977).

217. Cheryl Goss Weiss, *A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty*, 23 J. CORP. L. 65, 101 (1997).

218. *Mihara v. Dean Witter & Co.*, 619 F.2d 814 (9th Cir. 1980); see also *Miley v. Oppenheimer & Co.*, 637 F.2d 318 (5th Cir. Unit A Feb. 1981) (describing the three-part test); *Rolf*, 424 F. Supp. at 1039 (same).

219. See, e.g., *Wieringa v. Oppenheimer & Co.*, Nos. C 80-368, C 81-414, 1985 WL 510, at *10 (N.D. Ohio Mar. 7, 1985) ("A claim based on suitability requires that the plaintiff establish the defendants controlled the account, the defendants failed to adequately inquire into the investor's objectives, and that the investments in securities were too risky for his financial background or inconsistent with his investment objectives.").

220. The relationship between churning and unsuitability for excessive trading is complex and remains unsettled. Suitability is a developed legal doctrine in its own right. In our view, churning and suitability are different causes of action that rely, at least in federal securities law, on the same statute. The two appear to have different elements, meaning that a broker-dealer could be found liable for one but not the other, though in many cases a single fact pattern will give rise to liability for both churning and unsuitability for excessive trading. Excessive trading unsuitability and churning are both broker-dealer violations of the requirement to put the best interests of a customer first by trading too frequently. As such, it seems natural to consider the two as simply different names for the same violation. Indeed the NASD lends weight to this approach by discussing churning in NASD Rule Interpretation 2310-2, an interpretation of the suitability rule provided above. Several cases have

suitability violation. For example, in *Rafael Pinchas* the SEC held that “depending on a particular customer’s situation and account objectives, excessive trading, by itself, can violate NASD suitability standards by representing an unsuitable frequency of trading.”²²¹ Similarly, in *David A. Gingras* the SEC noted that “[e]xcessive trading is a form of unsuitable trading prohibited by Article III, Section 2 of the Rules of Fair Practice [the precursor to NASD Rule 2310].”²²²

Regardless of the exact relationship between churning and unsuitability for excessive trading, it is clear that plaintiffs have been successful in obtaining relief against brokers who engage in excessive trading, sometimes because the trading is regarded as unsuitable and sometimes because it is regarded as churning. Further complicating the discourse is the fact that claims for transaction form unsuitability on excessive trading grounds or churning often accompany those for product style suitability;²²³ brokers willing to trade excessively to generate profits are also often willing to buy overly risky securities for their clients.

It is also clear that significant problems of excessive trading and churning have plagued the mortgage market in recent years. In the mortgage context these problems take the form of encouraging borrowers to engage in an excessive number of costly refinancing transactions in order to generate fees for mortgage brokers. The protections available in the securities markets for excessive trading and churning also should be

combined discussions of suitability and churning, making it unclear if there is any difference. In addition, many of the elements looked at by courts in determining whether the offense has occurred are the same; for example, courts in both circumstances look at the “turnover rates” for securities and the return that would be required to recoup the commission in light of such rates. Yet it is hard to justify such a view given the fact that suitability has come to the forefront only in the last three decades while cases involving churning have been heard since the 1950s. In addition, the cases distinguishing the two, described more fully above, make it clear that the general jurisprudential view is that churning is not identical to suitability. While it may be a historical accident that the two are separated and future cases might bring the two closer together, it is not prudent to hold on to this approach at present. See *Krull v. SEC*, 248 F.3d 907, 913 (9th Cir. 2001); *O’Connor v. R.F. Lafferty & Co.*, 965 F.2d 893, 898 (10th Cir. 1992). Some scholars also hold on to this distinction: “The difference [between suitability and churning] is that churning deals with the quantity of the transactions executed for the customer while unsuitability deals with their quality.” POSER, *supra* note 134, § 3.03[B]. According to the First Circuit:

[a] churning claim requires plaintiff to show that the *quantity* of trades was excessive in light of plaintiff’s investment objectives. An unsuitability claim . . . requires plaintiff to show that the *quality* of stocks bought was inappropriate to his investment objectives. Thus, [the two] do not involve precisely the same issues or facts.

Tiernan v. Blyth, Eastman, Dillon & Co., 719 F.2d 1, 5 (1st Cir. 1983) (footnote omitted).

221. *Rafael Pinchas*, Exchange Act Release No. 41,816, 70 SEC Docket 1108 (Sept. 1, 1999), 1999 WL 680044, at *6.

222. *David A. Gingras*, Exchange Act Release No. 31,206, 50 S.E.C. 1286, 1289 n.4 (1992).

223. “[I]t appears to me that most courts recognize that the issue of suitability can arise either in conjunction with a churning claim or under Rule 10b-5 as a separate claim.” *Woodruff v. Merrill Lynch, Pierce, Fenner & Smith*, No. CV88-L-314, 1989 WL 224581, at *3 (D. Neb. 1989) (citing *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 333 (5th Cir. Unit A Feb. 1981); accord *Mihara v. Dean Witter & Co.*, 619 F.2d 814, 824 (9th Cir. 1980)); see, e.g., *Rolf*, 424 F. Supp. at 1021 (finding unsuitability in securities but no churning); *Howard*, Exchange Act Release No. 46,269, 78 SEC Docket 338 (July 26, 2002) (finding unsuitability in both product choice and excessive trading); *Rafael Pinchas*, Exchange Act Release No. 41,816, 70 SEC Docket 1108 (Sept. 1, 1999), 1999 WL 680044, at *6 (“[T]he level and type of trading in these accounts, including the in-and-out-trading, were unsuitable given the situations and objectives of these customers.”); *O’Neal*, Exchange Act Release No. 34,116, 56 SEC Docket 2093 (May 26, 1994) (finding churning and unsuitability of products).

available to people engaged in transactions in the mortgage market.

3. Suitability in Commission Structure

Suitability is also implicated by the structure of commissions earned by a broker-dealer from the customer. The NASD, in a 2003 Notice, warned broker-dealers about recommending a commission structure under which customers pay a flat fee to the broker-dealer for a number of services rather than paying for each transaction individually.²²⁴ The NASD relied on the SEC's release in *Wendell D. Belden*,²²⁵ which it:

construe[d] . . . as supporting the principle that the manner of purchase of a recommended security by an associated person, where that security otherwise would be suitable based on the investor's investment objectives, risk tolerance, and financial means, can render that recommendation unsuitable, and therefore violative of 2310 [the NASD suitability requirement], if there is an alternative basis upon which the security can be purchased to the pecuniary advantage of the investor.²²⁶

As a result, the SEC reasoned, recommendation by a broker-dealer that an investor work under a fee-based structure is unsuitable for an investor who trades infrequently and thus may benefit more from a fee structure based on individual transactions.²²⁷ The structure of commission payments for mortgage brokers is far more opaque than the commission structure for securities brokers. Clearly some effort should be made to structure the commissions paid to mortgage brokers so as to reduce the conflicts of interest between brokers and their clients. Mortgage brokers currently are compensated by both lenders and borrowers without the borrowers realizing that their lenders are compensating their brokers. Yield Spread Premium incentive schemes prevalent in the mortgage industry clearly give mortgage brokers perverse incentives to steer their customers towards higher cost loans. As one mortgage broker observed, "brokers see it as their right to make as much money as they can on a loan," making it unsurprising that "mortgage brokers steer borrowers to the lender that pays the highest fees to the broker" instead of to the lender that offers the best deal for the borrower.²²⁸

4. Distinguishing Transaction Form and Securities Product Suitability

Transaction form suitability is often lumped together with securities product suitability jurisprudentially due to the fact that both often appear together in cases of broker-dealer misconduct. It is not surprising that broker-dealers who would sell unsuitable securities would also do so under unsuitable circumstances, such as on margin

224. NASD, Notice to Members 03-68, Fee-Based Compensation: NASD Reminds Members That Fee-Based Compensation Programs Must Be Appropriate (Nov. 2003).

225. *Wendell D. Belden*, Exchange Act Release No. 47,859, 80 SEC Docket 563 (May 14, 2003), 2003 WL 21088079.

226. *Id.* at *4 n.5.

227. See Mills et al., *supra* note 129, § 6:1.2.

228. Barr, *supra* note 23.

or through excessive trading.²²⁹ For example, in *Rafael Pinchas*, the court held that “in assessing the suitability of the trades, we . . . have concluded that Pinchas’ trading for these accounts included the inappropriate purchase and sale of warrants and options [the ‘product’ part] and trading on margin [the ‘transaction form’ part].”²³⁰ In *Howard*, the court held that “both the nature of the securities that Howard recommended to Meeker and the level of trading activity were unsuitable.”²³¹ As a result, it is easy to view suitability holistically and avoid the nuanced distinction between securities product and transaction form suitability.

Adding to the blending of suitability doctrines is the fact that the line between the product and the transaction that gives rise to ownership or divestment of the product is becoming increasingly blurry. It is easy to categorize the shares of common stock in a corporation as informing the securities product suitability of a transaction while categorizing the purchase of such shares on margin as informing the transaction form suitability. It is harder, however, to determine where transactions in equity derivatives or structured products constitute securities for suitability purposes or a style in which underlying securities (or indices, in the case of structured products) are purchased. One could even argue that the purchase of a security on margin creates a complex security consisting in part of the cash flow from the underlying security and in part of the cash flow attributed to the margin purchase, thus blending the two suitability doctrines into one.

Yet, is it theoretically helpful to distinguish between the two when determining whether, and to what extent, suitability doctrine should be imported into other industries. In the abstract, a given tangible product is easy to distinguish from the method by which that product is purchased. As a result, if we can distinguish between securities product and transaction form suitability in the securities industry, in which products are particularly intangible and intertwined with the method in which they are purchased, we should be able to do so in most other industries. One would expect the two doctrines to diverge as products become more standardized, tangible, and easy to understand.

As stated above, the subprime mortgage crisis has led to calls for securities-like suitability requirements on mortgage brokers. Current proposals to import suitability standards into the mortgage industry generally seek to take the type of *product suitability* doctrine developed in the broker-dealer context and graft it onto mortgage origination and brokerage requirements. The basic idea is simple: If only “suitable” loans were available, economic downturns would not lead to a large number of defaults, and there would be no repeat of the subprime mortgage crisis. We hypothesize that transaction form suitability is a better overlay for the mortgage industry, particularly the subprime mortgage industry.

229. In addition to the cases listed below, see Steven E. Muth, Securities Act Release No. 8622, Exchange Act Release No. 52,551, 86 SEC Docket 956 (Oct. 3, 2005), 2005 WL 2428336, at *12 (finding a suitability infraction by Muth for both recommending highly risky securities and recommending these securities be purchased on margin: “Muth increased the risks to these customers by recommending that they purchase these speculative securities on margin.”).

230. Rafael Pinchas, Exchange Act Release No. 41,816, 70 SEC Docket 1108 (Sept. 1, 1999), 1999 WL 680044, at *6.

231. Howard, Exchange Act Release No. 46,269, 78 SEC Docket 338 (July 26, 2002), 2002 WL 1729157, at *3.

D. Previous Mortgage Suitability Proposals

Our proposal that some type of suitability be incumbent on mortgage brokers and originators is not unique. What is different about our proposal, however, is that we believe the *same* suitability causes of action should be applicable to subprime mortgages as are currently applicable to securities because the SEC already has jurisdiction over such mortgages. Here, we briefly discuss some previous mortgage suitability proposals.

Suitability in the mortgage industry began its life in state law and academic proposals. Many early movements in the direction of suitability have involved a required assessment of the borrower's ability to pay back the loan, which, as we discuss below, is a necessary but not sufficient condition for suitability.²³² Leading the charge has been North Carolina, which had one of the first laws requiring an inquiry into the ability of the borrower to pay²³³ and passed a law in 1999 making "flipping" mortgage loans illegal unless the loan provides a "tangible net benefit."²³⁴ Proponents have pointed out that HOEPA contains the notion that lenders need to assess a borrower's ability to pay.²³⁵ Laws in Colorado, Illinois, Maine, Minnesota, and Pennsylvania all have at least some hint of suitability, though they do not appear to require an explicit suitability determination.²³⁶ In addition, there have been a number of state and federal lawsuits asking the question of whether individuals can recover for cases in which they have been given unsuitable mortgages.²³⁷ Other commentators have noted that some state courts have engrafted fiduciary duties onto brokers but not originators.²³⁸

Formal proposals seem to have started with academic writing at the beginning of this decade. Perhaps the most cited early work is that of Kathleen C. Engel and Patricia A. McCoy, who argued that "without government intervention to impose a suitability standard, predatory lending will persist with devastating social consequences."²³⁹ Engel and McCoy's proposal requires that individuals only receive loans that they can pay out of current income, that fees have a basis in the risk to the lender, that subprime loans be made illegal for people who qualify for prime loans, and that there be an economic

232. See *infra* text accompanying note 267.

233. See Engel & McCoy, *supra* note 3, at 1319–20; Frank A. Hirsch, Jr., *The Evolution of a Suitability Standard in the Mortgage Lending Industry*, 12 N.C. BANKING INST. 21, 30 (2008). Hirsch notes that, in the newest incarnation of the North Carolina law:

In making the required determination of a borrower's ability to repay, lenders making rate-spread loans [a certain type of high-cost loan] must consider the borrower's: (1) credit history; (2) current and expected income; (3) current obligations; (4) employment status; and (5) 'financial resources other than the obligor's equity in the property that secures repayment of the' loan.

Id. (citing N.C. GEN. STAT. § 24-1.1F(c)(1) (2007)).

234. N.C. GEN. STAT. § 24-10.2(c); see also Hirsch, *supra* note 233, at 25.

235. Engel & McCoy, *supra* note 3, at 1319.

236. See Hirsch, *supra* note 233, at 30–33 (discussing bills in Colorado, Illinois, Maine, and Minnesota); Neil J. Morse, *Suitable or Not?*, 67 MORTGAGE BANKING 42 (2007) (covering Pennsylvania's legislation).

237. See Hirsch, *supra* note 233, at 36–42; Matthew P. McGuire & Frank A. Hirsch, Jr., *Subprime "Suitability" Case Rides Crest of Litigation Wave*, CONSUMER FIN. SERVICES L. REP., May 2, 2007; Miller & Paul, *supra* note 61, at 18.

238. See David Unseth, Note, *What Level of Fiduciary Duty Should Mortgage Brokers Owe Their Borrowers?*, 75 WASH. U. L.Q. 1737, 1741 (1997).

239. Engel & McCoy, *supra* note 3, at 1366.

rationale for all refinancing.²⁴⁰ The proposal hinges on the creation of a private right of action.²⁴¹

Before Engel and McCoy, however, Daniel S. Ehrenberg proposed that a more standards-based suitability criterion be required of mortgage originators. An unsuitability claim under Ehrenberg's proposal has five parts:

- (1) that the loan made with the borrower was unsuited to the borrower's financial circumstances, needs, and objectives; (2) that the defendant knew or reasonably believed that the loan was unsuited to the borrower's financial circumstances, needs, and objectives; (3) that the defendant made the unsuitable loan with the borrower anyway; (4) that, with scienter, the defendant made material misrepresentations (or failed to disclose material information) relating to the suitability of the loan; and (5) that the borrower justifiably relied to its detriment on the defendant's conduct.²⁴²

Most subsequent proposals for suitability borrow from Engel and McCoy or Ehrenberg's early writings.²⁴³

The outrage expressed by many over foreclosures and the salience of home ownership questions spurred federal lawmakers to act. In the Mortgage Reform and Anti-Predatory Lending Act of 2007,²⁴⁴ Representatives Miller, Watt, and Frank proposed

240. *Id.* at 1343–44.

241. *Id.* at 1339–40.

242. Daniel S. Ehrenberg, *If the Loan Doesn't Fit, Don't Take It: Applying the Suitability Doctrine to the Mortgage Industry to Eliminate Predatory Lending*, 10 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 117, 125–26 (2001).

243. See, e.g., Zywicki & Adamson, *supra* note 27, at 78–84 (pointing out some problems with suitability in the subprime mortgage crisis).

244. Mortgage Reform and Anti-Predatory Lending Act of 2007, H.R. 3915, 110th Cong. (2007); see Kenneth R. Harney, *Stricter Standards Sought for Lenders, Brokers*, WASH. POST, Jan. 27, 2007, at F1 (reporting on the belief that Representative Barney Frank might try to institute mortgage suitability); Stacy Kaper, *Industry Gains In Talks Over Frank Bill*, AM. BANKER, Nov. 2, 2007, at 2. The bill updates section 129A(a)(1)(B) of the Truth in Lending Act to require each mortgage originator to “diligently work to present the consumer with a range of residential mortgage loan products for which the consumer likely qualifies and which are appropriate to the consumer’s existing circumstances, based on information known by, or obtained in good faith by, the originator.” H.R. 3915 § 122 (emphasis added). Section 129A(a)(2)(B) requires that, for an appropriate consumer loan, “the mortgage originator determines in good faith, based on then existing information and without undergoing a full underwriting process, that the consumer has a reasonable ability to repay and, in the case of a refinancing of an existing residential mortgage loan, receives a net tangible benefit,” and that the loan “does not have predatory characteristics or effects (such as equity stripping and excessive fees and abusive terms).” *Id.* The focus on the “product” and the terms of the loan itself seem to indicate a product suitability mindset. The updated section 129B(a) requires loan originators to make a “reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms, and all applicable taxes, insurance, and assessments.” *Id.* § 201. This determination is to be made based on “consideration of the consumer’s credit history, current income, expected income the consumer is reasonably assured of receiving, current obligations, debt-to-income ratio, employment status, and other financial resources other than the consumer’s equity in the dwelling or real property that secures repayment of the loan.” *Id.* Conforming mortgages, those which GSEs are allowed to purchase, are presumed to pass these tests. The existence of such a safe harbor based on the attributes of the loan again hints towards a product suitability lens. However, the majority of subprime mortgages are not conforming and therefore fall into H.R. 3915’s ambit.

lowering HOEPA's high-cost loan trigger²⁴⁵ and eliminating yield spread premiums.²⁴⁶ However, Representative Frank made it clear that he did not intend H.R. 3195 to contain a suitability standard: "We felt a suitability standard was too vague. . . . We don't want to give people an obligation that is too vague and obscure because you can scare people away from doing anything. We think these are less subjective than suitability."²⁴⁷ The bill passed the House on November 15, 2007, but no further action appears to have been taken since.²⁴⁸ In May of 2007, Senator Chuck Schumer introduced the Borrower's Protection Act of 2007.²⁴⁹ Schumer does not appear to have shied away from the suitability label.²⁵⁰ Schumer's bill amends TILA by positively asserting a fiduciary relationship between borrower and lender,²⁵¹ requiring that lenders determine borrowers can repay their loans,²⁵² prohibiting steering, and requiring that lenders look at certain documentation when deciding whether to make a loan.²⁵³ The bill has not made it past the introduction stage of legislation.²⁵⁴ In December of 2007, Senator Chris Dodd of Connecticut introduced the Home Ownership Preservation and Protection Act of 2007.²⁵⁵ Dodd's bill requires, for subprime and nontraditional loans, that "each mortgage originator shall verify the reasonable ability of the borrower to pay the principal and interest on the loan and any real estate taxes and homeowner insurance fees and premiums."²⁵⁶ There does not seem to have been any further movement on this bill

245. See *Legislative Proposals on Reforming Mortgage Practices: Hearing on H.R. 3915 Before the H. Fin. Servs. Comm.*, 110th Cong. (2007) (statement of Marc Savitt, President-Elect, Nat'l Ass'n of Mortgage Brokers), available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/htsavitt102407.pdf.

246. *Id.* at 6-7.

247. Binyamin Appelbaum, *Frank's Bill Seeks Rules for Lenders*, BOSTON GLOBE, Oct. 23, 2007, at D1 (quoting Representative Barney Frank), available at http://www.boston.com/business/personalfinance/articles/2007/10/23/franks_bill_seeks_rules_for_lenders/.

248. *Legislative Highlights: Mortgage Reform Bill Advances in House*, ABI J., Dec.-Jan. 2008, at 8.

249. Borrower's Protection Act of 2007, S. 1299, 110th Cong. (2007); see also *Schumer, Others Propose First Major Legislation to Deal with Subprime Crisis as Weakening Housing Market Threatens Economy*, STATES NEWS SERVICE, May 3, 2007; Morse, *supra* note 236.

250. See Brian Collins, *Suitability in House Bill*, NATIONAL MORTGAGE NEWS, Apr. 2, 2007, at 1; Stacy Kaper, *A Suitability Bill in Works: Schumer*, AM. BANKER, Mar. 29, 2007, at 1; *Schumer, Others Propose First Major Legislation to Deal with Subprime Crisis as Weakening Housing Market Threatens Economy*, STATES NEWS SERVICE, May 3, 2007.

251. "In the case of a home mortgage loan, the mortgage broker shall be deemed to have a fiduciary relationship with the consumer, and each such mortgage broker shall be subject to all requirements for fiduciaries otherwise applicable under State or Federal law." S. 1299 § 2 (amending the Truth in Lending Act).

252. "Each mortgage originator shall, before entering into or otherwise facilitating any home mortgage loan, verify the reasonable ability of the borrower to pay the principal and interest on the loan, and any real estate taxes and homeowners insurance fees and premiums." *Id.*

253. *Id.*

254. See Govtrack, S. 1299: Borrower's Protection Act of 2007, <http://www.govtrack.us/congress/bill.xpd?bill=s110-1299> (last visited Mar. 9, 2009) (noting that the bill never became law).

255. Home Ownership Preservation & Protection Act of 2007, S. 2452, 110th Cong. (2007); see Patrick Rucker, *Sen. Dodd Proposes Mortgage Reform Bill*, WASH. POST, Sept. 5, 2007, http://www.washingtonpost.com/wp-dyn/content/article/2007/09/05/AR2007090501130_pf.html (reporting Senator Dodd's introduction of the Home Ownership and Protection Act).

256. S. 2452 § 201. In order to do this, the bill requires originators to look at borrower income, credit history, obligations and employment status, debt-to-income ratio, residual income, and other financial resources. *Id.* In addition, the bill makes prepayment penalties and yield spread premiums on subprime and nontraditional loans illegal. *Id.* § 129A. An agency relationship between borrower and lender is created.

either.²⁵⁷

While Congress has not been particularly quick to pass mortgage origination reform bills, the various agencies charged with overseeing elements of mortgage origination have addressed the problem more swiftly. In the summer of 2007, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration (the Agencies) issued a Final Guidance on Subprime Mortgage Lending.²⁵⁸ The Guidance expressed concern with the fact that mortgage borrowers were finding themselves subject to high floating rates after initial “teaser” fixed rates expired, that loans were being given with low or no documentation, and that borrowers were not provided the appropriate disclosure about their loans.²⁵⁹ Yet, the Agencies made it very clear that they did not mean to introduce suitability into the mortgage market, even for banks:

The Agencies disagree with the commenters who expressed concern that the proposed statement appears to establish a suitability standard under which lenders would be required to assist borrowers in choosing products that are appropriate to their needs and circumstances. These commenters argued that lenders are not in a position to determine which products are most suitable for borrowers, and that this decision should be left to borrowers themselves. It is not the Agencies’ intent to impose such a standard, nor is there any language in the Statement that does so.²⁶⁰

While the Final Guidance does provide some light on preferred mortgage terms, by its terms it only applies to banks and credit unions, not mortgage brokers, thereby limiting its reach.²⁶¹

Much more forceful is a set of rules passed by the Federal Reserve Board in July of 2008.²⁶² These rules will alter HOEPA and Regulation Z and take effect as of October 1, 2009.²⁶³ The new rules mimic HOEPA in that they create a high-cost loan trigger; the trigger in the rules is 1.5% above “average prime offer rates” for first-lien loans and 3.5% above “average prime offer rates” for second-lien loans.²⁶⁴ The purpose of these triggers, as stated in the rules, is to “cover the subprime market and generally exclude the prime

257. See Govtrack, S. 2452: Home Ownership Preservation and Protection Act of 2007, <http://www.govtrack.us/congress/bill.xpd?bill=s110-2452> (last visited Mar. 9, 2009) (noting that the bill never became law).

258. Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37,569 (July 10, 2007).

259. *Id.*

260. *Id.* at 37,572.

261. “The statement applies to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, savings and loan holding companies and their subsidiaries, and credit unions.” *Id.* at 37,570; see also Harney, *supra* note 18 (discussing the guidelines); Floyd Norris, *Regulators Set Rules to Limit Subprime Mortgage Lending*, N.Y. TIMES, June 30, 2007, at C2 (noting that the new rules will not affect all mortgage lenders).

262. Truth in Lending Act, 73 Fed. Reg. 44,522 (July 30, 2008) (to be codified at 12 C.F.R. pt. 226). While the coming of the rules was heavily publicized and eagerly awaited, the reaction to their actual announcement on July 14, 2008 was somewhat muted because of the concurrent Federal Reserve action on Freddie Mac and Fannie Mae.

263. *Id.*

264. *Id.* at 44,531.

market.”²⁶⁵ There are four major restrictions placed on such loans. The rules:

[1] Prohibit creditors from extending credit without regard to a consumer's ability to repay from sources other than the collateral itself; [2] Require creditors to verify income and assets they rely upon to determine repayment ability; [3] Prohibit prepayment penalties except under certain conditions; and [4] Require creditors to establish escrow accounts for taxes and insurance, but permit creditors to allow borrowers to cancel escrows 12 months after loan consummation.²⁶⁶

There is no suitability requirement, however.

A number of the proposals described above involve a requirement that the lender assert that the borrower is capable of paying the mortgage loan, a so-called “assessment of the ability to pay.” Federal law, and that of several states, requires mortgage brokers and/or originators to assure that their borrowers can afford payments under recommended mortgages.²⁶⁷ We take an assessment to pay to be a necessary, but not sufficient, precondition for a determination of suitability, and as such distinguish between these proposals and ours. If a borrower cannot repay a mortgage loan, he loses his house, and the equity built in it, to foreclosure. While lenders cannot, and cannot be asked to, forecast with perfect certainty everything that might happen to a borrower, a mortgage loan where there is a high probability the borrower will be unable to pay is, therefore, not suitable, any way we choose to define suitability. Any suitability criterion without an ability to pay provision is pointless. Ability to pay is rarely an issue in broker-dealer

265. *Id.* at 44,532.

266. *Id.* at 44,523. The first new set of rules, which requires creditors to look at the ability of the consumer to pay beyond the collateral offered, appears to deal with two concerns in predatory lending. The first is that creditors must look at a borrower's ability to pay, a term that is present in HOEPA and has hints of a move toward suitability. The second is that it specifically prohibits asset-based lending. To determine ability to pay, creditors should look at “current and reasonably expected income, employment, assets other than the collateral, current obligations, and mortgage-related obligations such as expected property tax and insurance obligations.” Truth in Lending Act, 73 Fed. Reg. at 44,543. The second set of requirements seeks to end “low-doc” and “no-doc” loans. In addition to these new rules on high-cost loans, the rules contain disclosure and advertising requirements and prohibitions against steering. In contrast to the joint Final Guidance described above, these rules are binding on every party that lends in the mortgage arena, *see* Press Release, Fed. Reserve Bd. (July 14, 2008), available at <http://www.federalreserve.gov/newsevents/press/bcreg/20080714a.htm> (noting that the new rule changes apply to all mortgage lenders), though not brokers. *See* Ted W. Lieu, *What the Fed Isn't Fixing: New Rules Don't Do Anything to Regulate a Big Subprime Player: The Mortgage Broker*, L.A. TIMES, July 16, 2008, at A19 (criticizing the Federal Reserve for failing to subject mortgage brokers to its regulation).

267. For example, N.C. GEN. STAT. § 24-1.1E(c)(2) (2007) requires that, in order to make a “high-cost home loan” a lender must “reasonably believe[] at the time the loan is consummated that one or more of the obligors . . . will be able to make the scheduled payments to repay the obligation based upon a consideration of their current and expected income, current obligations, employment status, and other financial resources.” *Id.* HOEPA requires that lenders assess the ability of the borrower to pay, based not solely on collateral. Engel & McCoy, *supra* note 3, at 1319. The Final Guidance states that “[t]he Agencies continue to believe that institutions should maintain qualification standards that include a credible analysis of a borrower's capacity to repay the loan according to its terms.” Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37,569, 37,571 (July 10, 2007). Barney Frank's proposed Mortgage Reform and Anti-Predatory Lending Act of 2007 states that “no creditor may make a residential mortgage loan unless the creditor makes a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms.” H.R. 3915, 110th Cong. § 201 (2007).

product suitability. Broker-dealers generally require that a client's account contain the money required for a transaction before that transaction is effected; thus, the ability to pay is not relevant. However, it is not foreign to broker-dealer suitability; ability to pay is a prerequisite to suitability, however, where stocks are bought on margin.

V. HOW SUITABILITY MIGHT HAVE SAVED HOMEOWNERS

SEC suitability oversight of subprime mortgages may have avoided much of the current economic crisis. In short, had borrowers not been put into mortgages they could not afford, or mortgages they could afford but that were not suitable for them, they would not have defaulted on home loan payments because they would not be making any home loan payments. Many of the primary problems with mortgage brokers leading to the subprime crisis have direct parallels in the three types of securities transaction form suitability claims.

Purchases of securities on margin²⁶⁸ involve the same concerns, notably the fear of an inability to pay and the negative consequences of debt, that so worry subprime mortgage analysts. Both serve the same purpose: allowing individuals to obtain goods now that they cannot or do not want to pay for now. Both have the same potential consequences.

Proponents of mortgage suitability also seek to solve the problem of overzealous brokers or originators convincing borrowers to refinance too often. Lenders are encouraged to do this because they receive commissions from refinancing. Proposed legislation attempts to solve this problem by requiring that all refinancing transactions satisfy a "net tangible benefit" test, requiring that the transaction is in the interest of the borrower.²⁶⁹ Securities suitability requires broker-dealers to refrain from excessive trading in customers' accounts.²⁷⁰ Any true mortgage suitability proposal must include a restriction on overly frequent trading, a restriction that will invariably be informed by churning and frequent transaction theory as they relate to securities transaction form suitability.²⁷¹

Finally, transaction form suitability requires that the commission structure by which broker-dealers are compensated not encourage individual employees to recommend unsuitable transactions to clients.²⁷² While this partially overlaps with ensuring that commission structures do not overly encourage frequent transactions, it also means that payment not be based on including in the mortgage loan or securities transaction risky

268. For the discussion of margin purchases in transaction form suitability, see *supra* Part IV(C)(1).

269. Barney Frank's Mortgage Reform and Anti-Predatory Lending Act requires that, for a mortgage loan to be appropriate, the borrower must in the case of a refinancing of an existing residential mortgage loan, receive a net tangible benefit. H.R. 3915, 110th Cong. § 202 (2007).

270. The doctrine of excessive trading as a violation of transaction form suitability is laid out in detail *supra* Part IV.C.2.

271. As discussed in detail above, the relationship between churning and the transaction form suitability violation through excessive trading remains unresolved. See *supra* Part IV.C.2. It is our hope that our division of securities suitability into product and transaction form suitability has the collateral effect of clearing up this debate.

272. This third strand is less developed than the previous two, but the authority behind it is strong, including a direct statement from the NASD. Fin. Indus. Regulatory Auth., FINRA Manual: NASD Rule 2310-3 (2008).

terms that generally inhere to the benefit of the broker-dealer company. For mortgage suitability, this means that a suitable compensation structure created by a broker-dealer for its employees cannot encourage recourse to risky 2/28 ARMs and the like unless absolutely necessary. Transaction form suitability again better informs mortgage suitability proposals than does product suitability.

VI. SOME PRACTICAL AND PUBLIC CHOICE CONSIDERATIONS

To this point our legal claim is that suitability doctrine in its current form can appropriately be interpreted to apply to the relationship between mortgage brokers and their clients, at least under certain types of mortgages—those whose success from the mortgagee's perspective depends on future interest rate movements and real estate prices, and those sold in connection with securitizations. If we are correct in our legal argument, then why has this argument not been put forward as a way to stop predatory subprime lending? Even if we are wrong in our legal analysis, an interesting question remains: Why does the law provide such robust protections for unsophisticated participants in U.S. securities markets and such weak protections for participants in U.S. mortgage financing? Certainly participants in mortgage financing are a far more diverse, less wealthy, less financially sophisticated group than participants in securities trading, and thus would seem to require *more*, not less, protection. This final Part of the Article offers some explanations why little or no effort has been made to expand the securities suitability requirements to the mortgage markets and suggests some reasons for this lack of effort. We conclude this Part with a brief foray into how suitability, and our proposal in particular, might have avoided the crisis, together with a brief analysis of the prospects that an SEC rule implementing our proposal would survive judicial scrutiny.

A. Markets Transform Themselves Faster than Law

As suggested above, one likely explanation is simply that the law has failed to keep up with the dramatic changes in the market for home mortgages. The understanding that homebuyers are protected in their financing transactions only by the law of caveat emptor is predicated on the fiction that the instruments being sold are still as they always were: simple, straightforward 30-year fixed-rate instruments that are easy to understand. Clearly, many of the mortgages currently outstanding, particularly those issued with no documentation and whose success depends not on the earnings capacity of the borrower but rather on the direction of asset prices and interest rates in the future, have at least as much in common with securities as they do with traditional mortgages. In addition, the current legal landscape is informed by the view that the agents selling the mortgages did not securitize them, but instead kept them as assets on their books until the principal and interest had been repaid, or until there was default and foreclosure. This, of course, closely aligned the interests of the mortgagee and the mortgagor, since, in sharp contrast with today, in bygone times, the person originating the mortgage was as interested in making sure that the principal and interest on that mortgage could be repaid as the person receiving the financing from the mortgage transaction. This is no longer the case, of course, as mortgage originators today are brokers who do not plan to hold the mortgage note, but rather to resell it immediately so that it can be bundled into a security and sold to investors.

B. The SEC Bureaucracy and Public Choice

Focus on the SEC's institutional orientation and its concerns for its traditional constituencies go a long way towards explaining why the Commission has not done anything to push greater suitability protections for mortgage holders.²⁷³ Strangely, the SEC has taken an active role in arguing that loan participations sold by commercial banks are securities,²⁷⁴ but has made no effort to expand its regulatory turf by claiming either that certain exotic mortgage instruments are securities or that transactions in which mortgages are securitized are transactions in connection with the purchase or sale of a security invoking Rule 10b-5. Strangely, the SEC appears anxious to extend its turf deep into the commercial banking industry, but not into the far more lightly regulated mortgage industry.²⁷⁵

The divergence is particularly perplexing given that the SEC was rebuffed in its effort to expand its regulatory turf into the commercial loan industry. This was largely because, as the Second Circuit observed in the *Banco Espanol* case, the services of the SEC are not needed in the loan participation market. The banks participating in this market are sophisticated investors who are already governed by a comprehensive regulatory scheme under the banking laws, thus making the "application of the securities laws . . . unnecessary."²⁷⁶

The odd juxtaposition between the SEC's usual loud and energetic focus on expanding its regulatory turf and its remarkable quiescence in the context of subprime mortgages is baffling. It appears to us that the most plausible explanation for the SEC's reluctance to regulate in this market is that there is no concentrated interest group with an interest in obtaining regulation in this area. While the potential targets of such regulation are banks that are highly concentrated and well-connected with the SEC, the beneficiaries are widely dispersed homeowners with little, if any, capacity for galvanizing into a political coalition that might be effective in spurring the SEC into action.²⁷⁷ Yet, if the SEC is not motivated to take action by the plight of legions of mortgage borrowers, then surely their predicament should have attracted the ministrations of the ever-observant plaintiffs' bar.

C. The Plaintiffs' Bar

The reason that the plaintiff's bar has not galvanized into action is easy to explain. It is not economical for lawyers to pursue lawsuits such as these on an individual basis. To generate legal fees sufficient to justify the costs that must be borne by the plaintiffs' lawyers, such lawsuits must be aggregated as a class action. The problem is that under the

273. See Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 949 (1994) (characterizing the SEC as a highly politicized organization intent on preserving its own bureaucratic turf).

274. *Banco Espanol de Credito v. Sec. Pac. Nat'l Bank*, 973 F.2d 51, 54 (2d Cir. 1992). The SEC was unsuccessful in this regard, as the appellate court agreed with the district court that short term loan participations were not securities. The SEC was not a party to the case but submitted an amicus curiae brief arguing that the loan participations were securities. *Id.* at 56.

275. Macey, *supra* note 273, at 941.

276. *Banco Espanol*, 973 F.2d at 55.

277. Similarly, the New York Attorney General has had little interest since a substantial cohort of the beneficiaries is in his jurisdiction while the majority of the parties harmed are not.

legal theories presented here the claims involve significant individualized issues of law and fact that would have to be retried on an individual basis. Under Rule 23 of the Federal Rules of Civil Procedure, which governs class actions, a class can only be certified if, *inter alia*, "the claims or defenses of the representative parties are typical of the claims or defenses of the class."²⁷⁸ Indeed suitability claims, even in the securities context, rarely pass the class action commonality requirement because of this requirement.²⁷⁹ Securities suitability, as discussed above, does not rely primarily on a private right of action for its enforcement; instead, the SEC or the SROs bring most suitability claims. This makes class action certification extremely problematic.²⁸⁰ Specifically, the argument made here has been that particular mortgages *might* be securities depending on specific, individualized attributes associated with those securities. In particular, we have identified the critical issue as whether the dominant features of the financial obligation make it look more like a traditional mortgage (which is not a security) or like a put option whose success or failure depends on factors outside of the control of the mortgagor, such as the future direction of interest rates and the future rise or decline in real estate asset values.

Alternatively, we have argued that the broker-dealer laws should also apply when a mortgage loan is made as part of a securitization. In such a circumstance the loan has been made "in connection with the sale of a security," namely the collateralized debt obligation (CDO) whose success depends on the stream of payments made by the mortgagors. The problem with overcoming the procedural obstacles to obtaining class action status under this theory is that there are no publicly circulated prospectuses issued in connection with mortgage transactions. Rather, each home sale is individual, and every mortgagor will have been told something different by the mortgage broker. Thus, there will be significant particularized issues of reliance, causation, and other matters in each of these cases that will not make it possible to achieve class action status.

D. Litigation Prospects

Finally, what are the prospects that our proposal would survive judicial scrutiny if it were implemented by the SEC? We believe the chances for success are high.

First, as documented throughout this paper, the issue discussed here presents a compelling need for regulatory action. High-pressure tactics by mortgage salespeople have caused hardship to people who were induced to take on mortgages that they could not afford. The pain of foreclosures has now metastasized into a financial crisis affecting all parts of the credit market and extending throughout the world. Although abuses in U.S. subprime mortgages cannot be the sole cause of these disturbing events, they appear to have been a trigger and certainly made a contribution to the disaster. Existing remedies for abusive practices have proven inadequate. Allowing the SEC to regulate the activities

278. FED. R. CIV. P. 23(a)(3).

279. *See, e.g.,* *Rowe v. Morgan Stanley Dean Witter*, 191 F.R.D. 398, 419 (D.N.J. 1999) (dismissing a class action for failure to state a claim upon which relief could be granted, including suitability and churning where both were seen by the court as too individualized, and requiring too much of a fact-intensive inquiry, for class action litigation).

280. *See* *Castano v. Am. Tobacco Co.*, 84 F.3d 734, 741 (5th Cir. 1996) (discussing the rigorous analysis of Rule 23 prerequisites before certifying a class).

of subprime mortgage salespeople would insert a federal regulator, capable of formulating uniform national standards, into a market that until now has been regulated in a haphazard fashion at best.

Second, as also documented above, there are cogent grounds for concluding that subprime mortgages qualify as “securities” or at least as instruments that are marketed in connection with the purchase and sale of securities. The embedded options that are so salient in the structure of the subprime mortgage contract makes it an appropriate candidate for treatment as a security, as does the fact that classifying such instruments as securities would not intrude on any other comprehensive regulatory scheme. More fundamentally, classing subprime mortgages as securities would appear consistent with the essential purpose of the federal securities laws: to ensure free and open capital markets and to protect vulnerable parties from abuse.

Third, any rulemaking adopted by the SEC would be entitled to what is known as “*Chevron* deference.”²⁸¹ *Chevron* deference is the term used to describe the deference that federal courts give to the interpretations of statutes made by administrative agencies where those interpretations fall within the agencies delegated zone of expertise.²⁸² Here, our argument is that the term “note” in the securities acts should be interpreted to include subprime mortgages, or that such mortgages are products created in connection with the purchase and sale of a security, which are subject to SEC regulation under Rule 10b-5. The SEC is directly responsible for the implementation of these statutes and rules. It is true that the SEC has not heretofore sought to regulate subprime mortgages or sales practices connected with such instruments. But, as documented above, the subprime market is a relatively new phenomenon. The now-familiar subprime mortgage, with its adjustable interest rates, prepayment penalties, “teaser” rates, minimal documentation requirements, and other features, was essentially unknown 20 years ago. Moreover, knowledge of the economic consequences of the subprime market is more recent still. Only in the past several years has it been clear that excesses and abuses in subprime lending have created risks, not only for borrowers and holders of subprime paper, but also for the financial and economic system as a whole. Even changes in long-held agency positions are entitled to substantial deference under *Chevron*.²⁸³ Even more deserving of deference is a regulation, such as the one we propose, which would cover new territory rather than reverse a long-held agency position. The SEC would clearly be well within its authority, under *Chevron*, to impose a new regulatory regime even if it has long had the authority to do so.

Fourth, the case for deference in the present case is particularly strong due to the fact that Congress has expressly indicated a wish to commit the topic to the SEC’s discretion. Rule 10b-5 is enacted pursuant to the authority of section 10(b) of the Securities

281. *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

282. *Id.* at 839–66.

283. As the Court noted in *Smiley v. Citibank (South Dakota), N.A.*, 517 U.S. 735 (1996):

Of course the mere fact that an agency interpretation contradicts a prior agency position is not fatal. Sudden and unexplained change, or change that does not take account of legitimate reliance on prior interpretation, may be arbitrary, capricious [or] an abuse of discretion. But if these pitfalls are avoided, change is not invalidating, since the whole point of *Chevron* is to leave the discretion provided by the ambiguities of a statute with the implementing agency.

Id. at 742. (citations omitted).

Exchange Act of 1934. Section 10(b), in turn, prohibits, in connection with the purchase or sale of a security, any manipulative or deceptive device or contrivance “in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”²⁸⁴ The intent of Congress to vest substantial rulemaking discretion in the SEC—a Congress that acted, in 1934, in the midst of a devastating economic and financial crisis bearing some similarities to events today—could not be clearer.

Accordingly, we have little doubt that a court would uphold an SEC rule declaring subprime mortgages (appropriately defined) to be “securities” and subjecting the activities of persons selling such securities to suitability rules similar to those already in place for conventional securities sales.²⁸⁵

VII. CONCLUSION

To a large extent the current economic crisis we are facing was brought about by massive and pervasive “reckless and even predatory mortgage lending.”²⁸⁶ The reckless lending that we observed had both a supply side and a demand side. On the supply side, mortgage loans were offered to people without the income or the wherewithal to repay these loans. The mortgage brokers, who were compensated on a commission basis and sometimes steered borrowers to the lender that paid the highest commissions, were indifferent to this problem because they knew that the mortgages were going to be securitized. On the demand side, many unsophisticated subprime borrowers were blissfully unaware of many of the draconian features of their loans, and they were unaware that they would be unable to avoid foreclosure if interest rates went up and housing prices went down.

The subprime mortgage market, in other words, has morphed into a securities market. As of this writing, one in six U.S. homeowners owes more on their mortgages than their homes are worth.²⁸⁷ Many of these people got into this situation because they refinanced their mortgages in order to pull out cash on the theory that property values would continue to rise, making such refinancing decisions appear to be risk-free.

Our argument is simple: The law should catch up with the market. Subprime borrowers who put little or no money down to obtain subprime mortgages without supplying any documentation to lenders are engaged in transactions that look at least as much like the purchase of securities in the form of options as a traditional mortgage transactions, especially when the mortgage securities are themselves bundled up, securitized, and resold. When the market went against such borrowers, the default option value of their mortgages dominated, foreclosures ensued, and the meltdown of 2008 began.

284. 15 U.S.C. § 78j(b) (2006).

285. Congress could, of course, make the case ironclad by explicitly delegating authority to the SEC to promulgate such a rule.

286. See *Bubble*, *supra* note 1.

287. See Tom Brown, “Under Water” Mortgages Are Growing Threat to U.S., REUTERS.COM, Oct. 22, 2008, <http://www.reuters.com/article/newsOne/idUSTRE49L01S20081022>.